

AUDIT REPORT

Clean Water State Revolving Fund

For the Year Ended
June 30, 2010



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

Department of Audit
Division of State Audit



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June 14, 2011

The Honorable Bill Haslam, Governor
and
Members of the General Assembly
and
Members of the Tennessee Local Development Authority
State Capitol
Nashville, Tennessee 37243
and
The Honorable Robert Martineau, Commissioner
Department of Environment and Conservation
401 Church Street, 1st Floor
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Clean Water State Revolving Fund for the year ended June 30, 2010. You will note from the independent auditor's report that an unqualified opinion was given on the fairness of the presentation of the financial statements.

Consideration of internal control over financial reporting and tests of compliance disclosed a deficiency, which is detailed in the Results of the Audit section of this report. The Department of Environment and Conservation's management has responded to the audit finding; the response is included following the finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit finding.

Sincerely,

A handwritten signature in black ink, appearing to read "Arthur A. Hayes, Jr." with a stylized flourish at the end.

Arthur A. Hayes, Jr., CPA
Director

AAH/ddm
11/017

State of Tennessee

Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit
Clean Water State Revolving Fund
For the Year Ended June 30, 2010

AUDIT OBJECTIVES

The objectives of the audit were to consider the fund's internal control over financial reporting; to determine compliance with certain provisions of laws, regulations, contracts, and grant agreements; to determine the fairness of the presentation of the financial statements; and to recommend appropriate actions to correct any deficiencies.

COMPLIANCE FINDING

The Management and Staff of the Department of Environment and Conservation Did Not Familiarize Themselves With Federal Requirements in OMB Circular A-133, Section 400(d), Which Resulted in Noncompliance and \$10,506,832 in Related Federal Questioned Costs*

Management and staff of the Department of Environment and Conservation did not

- notify subrecipients that the loans they were receiving were funded by federal Capitalization Grants for Clean Water State Revolving Funds and Capitalization Grants for Drinking Water State Revolving Funds,
- provide subrecipients with required information including the Catalog of Federal Domestic Assistance (CFDA) titles and numbers of the federal programs and the names of the federal agency, and
- ensure subrecipients received the required audits.

The entire amount of the 2009 loan to Metropolitan Nashville and Davidson County, \$10,506,832, was questioned. These funds were questioned because they were not audited as part of Nashville's single audit due to the Department of Environment and Conservation's failure to comply with federal subrecipient monitoring requirements.

* This is a material noncompliance finding that is required to be reported under generally accepted government auditing standards.

OPINION ON THE FINANCIAL STATEMENTS

The opinion on the financial statements is unqualified.

**Audit Report
Clean Water State Revolving Fund
For the Year Ended June 30, 2010**

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Clean Water State Revolving Fund For the Year Ended June 30, 2010

INTRODUCTION

POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the Clean Water State Revolving Fund. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

BACKGROUND

The Clean Water State Revolving Fund was created in 1987 by an act of the General Assembly, codified as Section 68-221-1004, *Tennessee Code Annotated*. The fund is intended, in coordination with state and federal assistance programs, to provide local governments and utility districts with low-cost financial assistance to improve and protect water quality and public health. The fund was established as a revolving loan fund under Title VI of the Clean Water Act, administered by the United States Environmental Protection Agency. The fund’s loans are provided to local governments, at or below market interest rates, to construct facilities whose purposes may include collection, treatment, and disposal of wastewater. Local governments pledge to repay the loan principal and interest through a variety of methods including assessing, levying, and collecting ad valorem taxes on all taxable property within their jurisdiction; pledging their full faith and credit and unlimited taxing power; fixing, levying, and collecting fees and other charges for the use of the wastewater facility; and pledging any other security deemed necessary as determined by the Tennessee Local Development Authority.

ORGANIZATION

The Clean Water State Revolving Fund is governed by the Tennessee Local Development Authority (TLDA) and the Department of Environment and Conservation. The TLDA administers the fund, adopts the rules and regulations for the fund’s administration, and deposits all receipts from repayments of loans into the fund. The department conducts engineering and

environmental studies on the planning and design of the facilities, approves applications for facility construction, and recommends to TLDA an appropriate financing method for each facility. In the event of missed payments, the Water and Wastewater Financing Board or the Utility Management Review Board is empowered to effect reasonable user rate increases or to effect system efficiencies through the negotiated consolidation of certain wastewater facilities.

AUDIT SCOPE

The audit was limited to the period July 1, 2009, through June 30, 2010, and was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in generally accepted government auditing standards. Financial statements are presented for the year ended June 30, 2010, and for comparative purposes, the year ended June 30, 2009. The Clean Water State Revolving Fund forms an integral part of state government and as such has been included as an enterprise fund in the *Tennessee Comprehensive Annual Financial Report*.

OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. to consider the fund's internal control over financial reporting as a basis for designing auditing procedures for the purpose of expressing an opinion on the financial statements;
2. to determine compliance with certain provisions of laws, regulations, contracts, and grant agreements;
3. to determine the fairness of the presentation of the financial statements; and
4. to recommend appropriate actions to correct any deficiencies.

PRIOR AUDIT FINDINGS

There were no findings in the prior audit report.

OBSERVATIONS AND COMMENTS

MANAGEMENT'S RESPONSIBILITY FOR RISK ASSESSMENT

Auditors and management are required to assess the risk of fraud in the operations of the entity. The risk assessment is based on a critical review of operations considering what frauds could be perpetrated in the absence of adequate controls. The auditors' risk assessment is limited to the period during which the audit is conducted and is limited to the transactions that the auditors are able to test during that period. The risk assessment by management is the primary method by which the entity is protected from fraud, waste, and abuse. Since new programs may be established at any time by management or older programs may be discontinued, that assessment is ongoing as part of the daily operations of the entity.

Risks of fraud, waste, and abuse are mitigated by effective internal controls. It is management's responsibility to design, implement, and monitor effective controls in the entity. Although internal and external auditors may include testing of controls as part of their audit procedures, these procedures are not a substitute for the ongoing monitoring required of management. After all, the auditor testing is limited and is usually targeted to test the effectiveness of particular controls. Even if controls appear to be operating effectively during the time of the auditor testing, they may be rendered ineffective the next day by management override or by other circumventions that, if left up to the auditor to detect, will not be noted until the next audit engagement and then only if the auditor tests the same transactions and controls. Furthermore, since staff may be seeking to avoid auditor criticisms, they may comply with the controls during the period that the auditors are on site and revert to ignoring or disregarding the controls after the auditors have left the field.

The risk assessments and the actions of management in designing, implementing, and monitoring the controls should be adequately documented to provide an audit trail both for auditors and for management, in the event that there is a change in management or staff, and to maintain a record of areas that are particularly problematic. The assessment and the controls should be reviewed and approved by the head of the entity.

FRAUD CONSIDERATIONS

Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit*, promulgated by the American Institute of Certified Public Accountants requires auditors to specifically assess the risk of material misstatement of an audited entity's financial statements due to fraud. The standard also restates the obvious premise that management, not the auditors, is primarily responsible for preventing and detecting fraud in its own entity. Management's responsibility is fulfilled in part when it takes appropriate steps to assess the risk of fraud within the entity and to implement adequate internal controls to address the results of those risk assessments.

During our audit, we discussed these responsibilities with management and how management might approach meeting them. We also increased the breadth and depth of our inquiries of management and others in the entity as we deemed appropriate. We obtained formal assurances from top management that management had reviewed the entity's policies and procedures to ensure that they are properly designed to prevent and detect fraud and that management had made changes to the policies and procedures where appropriate. Top management further assured us that all staff had been advised to promptly alert management of all allegations of fraud, suspected fraud, or detected fraud and to be totally candid in all communications with the auditors. All levels of management assured us there were no known instances or allegations of fraud that were not disclosed to us.

RESULTS OF THE AUDIT

AUDIT CONCLUSIONS

Internal Control

As part of the audit of the Clean Water State Revolving Fund's financial statements for the year ended June 30, 2010, we considered internal control over financial reporting as a basis for designing auditing procedures for the purpose of expressing an opinion on the financial statements, as required by auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in generally accepted government auditing standards. Consideration of internal control over financial reporting disclosed no material weaknesses.

Compliance and Other Matters

The results of our audit tests disclosed an instance of noncompliance that is required to be reported under generally accepted government auditing standards. This instance of material noncompliance, along with the recommendation and management's response, is included in the Finding and Recommendation section.

Fairness of Financial Statement Presentation

The Division of State Audit has rendered an unqualified opinion on the Clean Water State Revolving Fund's financial statements.



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**Report on Internal Control Over Financial Reporting and on
Compliance and Other Matters Based on an Audit of
Financial Statements Performed in Accordance With
*Government Auditing Standards***

March 22, 2011

The Honorable Bill Haslam, Governor
and
Members of the General Assembly
and
Members of the Tennessee Local Development Authority
State Capitol
Nashville, Tennessee 37243
and
The Honorable Robert Martineau, Commissioner
Department of Environment and Conservation
401 Church Street, 1st Floor
Nashville, Tennessee 37243

Ladies and Gentlemen:

We have audited the financial statements of the Clean Water State Revolving Fund, as of and for the year ended June 30, 2010, and have issued our report thereon dated March 22, 2011. 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 generally accepted government auditing standards.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the fund'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, but not for the purpose of expressing an opinion on the effectiveness of the fund's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the fund's internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. *A material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, 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 above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the fund's financial statements 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 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 the following instance of noncompliance or other matters that is required to be reported under generally accepted government auditing standards:

- The management and staff of the Department of Environment and Conservation did not familiarize themselves with federal requirements in OMB Circular A-133, Section 400 (d), which resulted in noncompliance and \$10,506,832 in related federal questioned costs.

This instance is described in the Finding and Recommendation section of this report.

The Department of Environment and Conservation's response to the finding identified in our audit is included in the Finding and Recommendation section of this report. We did not audit the department's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the General Assembly of the State of Tennessee, members of the Tennessee Local Development Authority, management, and

March 22, 2011
Page Three

others within the entity 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.

Sincerely,

A handwritten signature in black ink that reads "Arthur A. Hayes, Jr." with a stylized flourish at the end.

Arthur A. Hayes, Jr., CPA
Director

AAH/ddm

FINDING AND RECOMMENDATION

The management and staff of the Department of Environment and Conservation did not familiarize themselves with federal requirements in OMB Circular A-133, Section 400(d), which resulted in noncompliance and \$10,506,832 in related federal questioned costs

Finding

Because management and staff of the Department of Environment and Conservation (TDEC) did not adequately familiarize themselves with OMB Circular A-133, Section 400(d), which defines the responsibilities of pass-through entities who pass federal grant funds to subrecipients, the department and the subrecipients who received and spent federal funds did not comply with these requirements, resulting in federal questioned costs of \$10,506,832.

Background Information

The Environmental Protection Agency awarded capitalization grants to the state to create and maintain the Clean Water State Revolving Fund and the Drinking Water State Revolving Fund programs. Under the Clean Water program, the state encourages (1) construction of wastewater treatment facilities to meet the enforceable requirements of the Clean Water Act; (2) increasing the emphasis on nonpoint source pollution control and protection of estuaries; and (3) establishing permanent financing institutions to provide continuing sources of financing to maintain water quality. The Clean Water fund provides loans and other types of financial assistance (but not grants) to qualified communities and local agencies; it is a permanent revolving fund. Under the Drinking Water program, TDEC established the revolving loan fund to assist public water systems in financing the costs of infrastructure needed to achieve or maintain compliance with Safe Drinking Water Act requirements and protect the public health objectives of the act. The Drinking Water fund can be used to provide loans and other types of financial assistance for qualified communities, local agencies, and private entities. The federal regulations also allow states to set aside certain percentages of their capitalization grant or allotment for various activities that promote source water protection and enhanced water systems management.

To carry out the Clean Water and Drinking Water programs, the state as part of its initial application for the capitalization grant designated TDEC the responsibility to administer the State Revolving Fund Loan Program (SRFLP) in accordance with the Safe Drinking Water Act. The SRFLP provides local governments, utility districts, and water and/or waste water authorities (subrecipients) with low-cost loans for the construction of waste water and drinking water facilities. The SRFLP is funded by the federal capitalization grants, state matching dollars, and the repayment of previous loans. Each year, TDEC management determines the amount available for loans to subrecipients and makes loan awards to subrecipients as approved by the

governing board, the Tennessee Local Development Authority. The SRFLP Manager notifies subrecipients that they have been approved for a loan, though no money is loaned until the subrecipient incurs project expenses and submits reimbursement requests. Once a subrecipient incurs costs and requests reimbursement, the SRFLP Manager approves the reimbursement request and authorizes the loan payment to the subrecipient from the State Revolving Fund.

Because the State Revolving Fund contains federal and state funds, the SRFLP manager must determine which source of funds will be used to reimburse each loan reimbursement request. Based on our discussions with the SRFLP manager, he stated that in order to draw down federal reimbursement dollars sooner, for the Clean Water State Revolving Fund projects he has historically awarded federal loan funds to larger subrecipients who have multiple projects. Also, the manager stated that this method of awarding loan funds reduces the chances of smaller subrecipients incurring the cost of a single audit, which is required when subrecipients receive and spend federal funds above a certain threshold. According to the SRFLP manager, he does not determine whether federal or state funds make up each loan at the time the loan is awarded, but rather at the time reimbursements are made. The Program Manager told us that he does not notify subrecipients at either time whether the loan award included federal funds. In fiscal year 2010, the Program Manager notified subrecipients when their loan agreements included federal dollars from the American Recovery and Reinvestment Act (ARRA); however, specific award information was not included in that notification. When subrecipients are unaware that they have received federal funds, the risk of federal noncompliance by TDEC and the subrecipients is increased.

OMB A-133, Section 400(d) Requirements

The Office of Management and Budget (OMB) Circular A-133, Section 400(d), requires that pass-through entities exercise seven specific oversight responsibilities for the federal awards it makes to its subrecipients. However, we found that TDEC management and staff only addressed one of these seven responsibilities. Specifically, TDEC relies on its compliance with the Department of Finance and Administration's Policy 22, Subrecipient Contract Monitoring, to ensure subrecipients who receive federal funding through TDEC are monitored and applicable federal compliance requirements are met. The state's Policy 22 specifically allows state departments and agencies to address the compliance with Section 400(d)(3), to "*[m]onitor the activities of subrecipients as necessary to ensure that Federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.*"

However, management and staff had not sufficiently familiarized themselves with the remaining responsibilities of Section 400(d) and failed to ensure compliance with these specific requirements: subrecipients' audit requirements, the issuance of management decisions for subrecipients' audit findings, and notifying the subrecipient of specific award information.

In addition, based on our testwork, we determined that none of the Clean Water State Revolving Fund and Drinking Water State Revolving Fund subrecipients' loan agreements were included in the department's 2009 and 2010 federal fiscal year Policy 22 annual monitoring

plans. Therefore, because management failed to include the loan agreements in the population of subrecipients, the loan agreements were not subject to monitoring efforts through a Policy 22 review. We identified 11 Clean Water fund and Drinking Water fund subrecipients in 2009 and 36 subrecipients in 2010 that were awarded federal loans and reimbursed for expenses totaling \$15,090,534.57 and \$31,064,580.27, respectively. But these subrecipients were not monitored for compliance requirements related to Clean Water fund and Drinking Water fund program requirements or for requirements under OMB A-133, Section 400(d).

We did determine that programmatic staff performed inspections of subrecipient construction sites to ensure that work performed conformed to state-approved plans, agreed to reimbursement requests submitted, and used agreed-upon materials; however, their reviews did not address specific program or OMB A-133, Section 400(d) requirements.

Subrecipients' Audits and Management Decisions

Based on our interviews, follow-up meetings, and e-mails, TDEC officials outlined what they believed were their responsibilities regarding subrecipients' independent audit reports. Specifically, we also found that the Division of Water Supply and the Division of Internal Audit were unaware that it was their responsibility to ensure subrecipients were audited in accordance with OMB Circular A-133, Section 400(d)(4), and erroneously believed that the subrecipient audit report requirement was the responsibility of the Tennessee Office of the Comptroller of the Treasury. However, OMB Circular A-133, Section 400(d) (4), states that ensuring subrecipients meet their audit requirements is the pass-through entity's responsibility. Section 400(5) also requires the pass-through agency to issue management decision letters to subrecipients within six months of an audit report containing findings.

Staff auditors of the Division of Internal Audit performed desk reviews of Clean Water fund and Drinking Water fund subrecipients as part of their normal monitoring activities, but because they believed the Comptroller's Office was responsible for subrecipient audit reports, the division's internal auditors did not look for the subrecipients' audit reports.

We reviewed all 11 Clean Water fund and Drinking Water fund subrecipients who received federal loans in 2009, and we found the following noncompliance:

- Based on a comparison of a listing of fiscal year 2009 federal disbursements to subrecipients (generated by the Office of State and Local Finance) to subrecipients' fiscal year 2009 independent audit reports, we found that Metropolitan Nashville and Davidson County (Nashville) expended \$10,506,832.98 in Clean Water federal funds in fiscal year 2009 but did not include the expenditures on its Schedule of Expenditures of Federal Awards. In addition, the independent auditors did not audit the program as a major federal program for the year ended June 30, 2009. Since 1991, Nashville has been awarded 26 separate Clean Water fund loans totaling over \$200 million in state and federal funds, but Nashville's independent auditors have never audited the Clean Water fund as a major program, and Nashville has never included the funds on its SEFA. OMB Circular A-133, Section 400(d)(4), requires

TDEC to “[e]nsure that subrecipients expending \$300,000 (\$500,000 for fiscal years ending after December 31, 2003) or more in Federal awards during the subrecipient’s fiscal year have met the audit requirements of this part for that fiscal year.” The SRFLP Manager’s failure to notify subrecipients when they are awarded federal loans seriously hinders Nashville’s (and other cities’) independent auditors from identifying the dollars as federal and auditing them appropriately. For fiscal year 2009, TDEC awarded and reimbursed 100% of the state’s Clean Water fund federal loan dollars to Nashville. All other Clean Water fund subrecipients were awarded and reimbursed with either state matching funds or repaid dollars from previous loans.

Because TDEC management and staff did not ensure this subrecipient was audited for the Clean Water program, they cannot be assured federal funds were spent in accordance with applicable requirements. We have questioned the entire loan payments to Metropolitan Nashville and Davidson County (Nashville) totaling \$10,506,832.98 in Clean Water federal funds for the year ended June 30, 2009.

We also found, based on interviews with the Director of Internal Audit and staff, that they did not know that 6 of the 11 subrecipients in 2009 had reached the federal expenditure threshold and were required to have an audit completed within 9 months after the year ended June 30, 2009, as required by Section 320(a) of OMB Circular A-133. This section states that “[t]he audit shall be completed and the data collection form described in paragraph (b) of this section and reporting package described in paragraph (c) of this section shall be submitted within the earlier of 30 days after receipt of the auditor’s report(s), or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit.” In addition to TDEC management and staff not knowing that subrecipient audits were even required, we found 3 of the 6 subrecipients did not ensure their audits were completed within 9 months after their fiscal year-end. Ultimately, these subrecipients’ audits were completed; however, the audits were 56, 77, and 148 days beyond the 9-month deadline.

- As part of our review, we identified only one independent auditor’s report with audit findings. The City of Livingston audit report contained two findings concerning the Clean Water program. Because TDEC did not comply with the requirement to ensure subrecipients’ audit reports were received, the department was also unaware of the findings in this report and did not comply with the requirement to issue a management decision on the audit findings. OMB Circular A-133, Section 400(d)(5), requires the “pass-through entity” (TDEC) to “[i]ssue a management decision on audit findings within six months after receipt of the subrecipient’s audit report and ensure that the subrecipient takes appropriate and timely action.” We notified both Division of Internal Audit and Division of Water Safety staff on August 27, 2010, of this independent auditor’s report and the findings on the City of Livingston. According to both the Director of Internal Audit and the SRFLP Manager, neither was aware of the

requirement to issue a management decision letter to the City of Livingston by September 30, 2010. After we brought this to management's attention, TDEC officials issued the management decision letter to the City of Livingston on December 22, 2010, 83 days after the six-month deadline.

Award Identification

OMB Circular A-133, Section 400(d)(1), states that a pass-through entity must “[i]dentify Federal awards made by informing each subrecipient of CFDA title and number, award name and number, award year, if the award is R&D, and name of Federal agency. When some of this information is not available, the pass-through entity shall provide the best information available to describe the Federal award.”

As noted above, we identified 36 Clean Water fund and Drinking Water fund subrecipients who were awarded federal loans for the fiscal year ended June 30, 2010, and 11 subrecipients who were awarded federal loans for the fiscal year ended June 30, 2009, but TDEC failed to notify the subrecipients either at the time of the award or at the time of reimbursement of the required information noted above.

Based on discussions with the SRFLP Manager, he was unaware of the requirement to notify subrecipients of the required award information. After we informed management on August 12, 2010, of this award notification requirement, they amended their loan agreements for new loans awarded after September 1, 2010, to include the best information available to describe the federal award.

As documented in this finding and based on meetings, inquiries, and observation, we determined that TDEC officials were unaware of certain OMB Circular A-133 requirements concerning subrecipient monitoring. As a result, TDEC management has failed to fulfill its responsibility as a pass-through entity to ensure controls governing subrecipient monitoring were in place and operating effectively to mitigate the risks of noncompliance, fraud, waste, and abuse within the federal programs. In addition, failure to exercise proper oversight of subrecipients increases the risk that the mission of the Clean Water fund and Drinking Water fund programs will not be carried out.

Recommendation

The Commissioner of TDEC should require all employees who are responsible for federal grants to familiarize themselves with all federal requirements and take immediate action to ensure TDEC is in compliance with all federal regulations. The Commissioner should have staff update their risk assessment to include the risks identified in this finding. Management and staff should develop adequate controls to mitigate the risks identified and then ensure these controls are placed in operation to ensure compliance with federal regulations and to mitigate risks of fraud, waste, and abuse. Specifically, management should

- ensure that the population of subrecipients includes all Clean Water State Revolving Fund and Drinking Water State Revolving Fund subrecipients;
- ensure subrecipients are informed of federal award identification at the time of the award;
- ensure subrecipients who receive more than \$500,000 in federal dollars annually obtain the required independent auditor's report timely; and
- issue management decision letters related to findings in independent audit reports timely and ensure that corrective action is taken promptly.

Management's Comment

We concur. Management and staff will develop controls to mitigate the risks identified and ensure these controls are in place to ensure compliance with federal regulations to mitigate risks of fraud, waste and abuse. Risk assessments due December 31, 2011, will include the risks identified in this finding. Below are management's responses to each recommendation.

Recommendation 1: Ensure that the population of subrecipients includes all Clean Water State Revolving Fund and Drinking Water State Revolving Fund subrecipients.

Tennessee Department of Environment and Conservation's (TDEC) Subrecipient Monitoring Plan submitted on September 27, 2010, to Finance & Administration (F&A) included all Clean Water State Revolving Fund (CWSRF) and Drinking Water State Revolving Fund (DWSRF) subrecipients. F&A's Office of Audit and Consulting approved TDEC's Subrecipient Monitoring Plan on November 17, 2010. All future submittals to F&A will include all the CWSRF and DWSRF loan recipients.

Recommendation 2: Ensure subrecipients are informed of federal award identification at the time of the award.

Loan agreements have been amended for new loans awarded after September 1, 2010, to provide the following information to loan recipients: (1) CFDA Title; (2) CFDA #; (3) Research and Development Award (Yes or No); (4) Grant Number; (5) Federal Awarding Agency; (6) the location of the website to obtain confirmations of actual federal funding at fiscal year end from the Tennessee Comptroller of the Treasury, Division of Municipal Audit website at <http://www.tn.gov/comptroller>; and (7) OMB Circular A-133 Audit Requirements. The Division of Internal Audit (DIA) contacted the Office of State and Local Finance¹ to discuss including the amount of federal funds disbursed with each payment from the State Revolving Fund to every loan recipient. As of March 2, 2011, letters sent to loan recipients from the Office of State and Local Finance will include the amount of federal funds disbursed to each loan recipient.

¹With the Comptroller of the Treasury's office.

Recommendation 3: Ensure subrecipients who receive more than \$500,000 in federal dollars annually obtain the required independent auditor's report timely.

Pursuant to Section 320(a) of OMB Circular A-133, DIA has implemented procedures to check the Federal Audit Clearing House to verify that TDEC's subrecipients and loan recipients submit their data collection form and reporting package within nine months² after the end of the audit period. If a TDEC subrecipient or loan recipient has not submitted their data collection form and reporting package by March 31st each year, DIA will check the Comptroller's website for audit reports submitted to Municipal and County Audit. If the audit reports indicate that a subrecipient or loan recipient should have submitted their data collection form and reporting package, DIA will issue letters requesting a reply from the subrecipient or loan recipient with an explanation for the lack of submission.

Recommendation 4: Issue management decision letters related to findings in independent audit reports timely and ensure that corrective action is taken promptly.

The procedures implemented above (see Recommendation 3) by DIA include reviewing data collection forms to ascertain if the audit reports include findings against TDEC federal awards. DIA will notify program management and provide guidance to them in issuing management decision letters related to findings timely and ensure that corrective action is taken promptly.

Regarding the \$10,506,833 of questioned costs for a loan to Metropolitan Nashville and Davidson County (Nashville), DIA issued a letter to Nashville on October 15, 2010, requesting corrective action to: (1) amend their Single Audit Report for the fiscal year ending June 30, 2009³, and (2) submit a copy of the amended audit report to the State of Tennessee Comptroller's Office, Division of County Audit. DIA received a response from Nashville on November 29, 2010. After receiving guidance from the Environmental Protection Agency (EPA) on January 26, 2011, supporting our request for correction action, TDEC met with Nashville representatives on February 22, 2011. Nashville indicated they would comply with the corrective action. DIA received an e-mail from Nashville on March 7, 2011, indicating the status of their corrective action. Nashville will amend and reissue the audit report for the year ending June 30, 2009, by March 31, 2011.

² The majority of TDEC's subrecipients have a year-end of June 30 and a March 31 deadline to submit the reporting package to the Federal Audit Clearing House.

³ To include an amended submittal of the data collection form described in paragraph (b) and reporting package described in paragraph (c) of Section 320(a) of OMB Circular A-133.



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500
JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-1402
PHONE (615) 401-7897
FAX (615) 532-2765

Independent Auditor's Report

March 22, 2011

The Honorable Bill Haslam, Governor
and
Members of the General Assembly
and
Members of the Tennessee Local Development Authority
State Capitol
Nashville, Tennessee 37243
and
The Honorable Robert Martineau, Commissioner
Department of Environment and Conservation
401 Church Street, 1st Floor
Nashville, Tennessee 37243

Ladies and Gentlemen:

We have audited the accompanying statements of net assets of the Clean Water State Revolving Fund, an enterprise fund of the State of Tennessee, as of June 30, 2010, and June 30, 2009, and the related statements of revenues, expenses, and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the fund's management. Our responsibility is to express an opinion on these financial statements, based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in generally accepted government auditing standards. 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 audits provide a reasonable basis for our opinion. Tennessee statutes, in addition to audit responsibilities, entrust certain other

March 22, 2011
Page Two

responsibilities to the Comptroller of the Treasury. Those responsibilities include serving as a member of the board of directors of Tennessee Local Development Authority. We do not believe that the Comptroller's service in this capacity affected our ability to conduct an independent audit of the Clean Water State Revolving Fund.

As discussed in Note 1, the financial statements present only the Clean Water State Revolving Fund, an enterprise fund, and do not purport to, and do not, present fairly the financial position of the State of Tennessee, as of June 30, 2010, and June 30, 2009, and the changes in its financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Clean Water State Revolving Fund of the State of Tennessee, as of June 30, 2010, and June 30, 2009, and the changes in its financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with generally accepted government auditing standards, we have also issued our report dated March 22, 2011, on our consideration of the Clean Water State Revolving Fund'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 internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with generally accepted government auditing standards and should be considered in assessing the results of our audit.

Sincerely,

A handwritten signature in black ink, appearing to read "Arthur A. Hayes, Jr.", written in a cursive style.

Arthur A. Hayes, Jr., CPA
Director

AAH/ddm

Clean Water State Revolving Fund
Statements of Net Assets
June 30, 2010, and June 30, 2009

	<u>June 30, 2010</u>	<u>June 30, 2009</u>
(Expressed in Thousands)		
ASSETS		
Current assets:		
Cash (Note 2)	\$ 205,813	\$ 213,768
Receivables		
Loans receivable	30,231	28,210
Interest receivable on loans	<u>113</u>	<u>-</u>
Total current assets	<u>236,157</u>	<u>241,978</u>
Noncurrent assets:		
Loans receivable	<u>527,926</u>	<u>490,494</u>
Total noncurrent assets	<u>527,926</u>	<u>490,494</u>
Total assets	<u>764,083</u>	<u>732,472</u>
LIABILITIES		
Current liabilities:		
Accounts payable	543	-
Payable to borrowers (Note 3)	<u>24</u>	<u>60</u>
Total current liabilities	<u>567</u>	<u>60</u>
Noncurrent liabilities:		
Customer deposits payable (Note 2)	<u>4,333</u>	<u>4,002</u>
Total noncurrent liabilities	<u>4,333</u>	<u>4,002</u>
Total liabilities	<u>4,900</u>	<u>4,062</u>
NET ASSETS		
Unrestricted	<u>759,183</u>	<u>728,410</u>
Total net assets	<u>\$ 759,183</u>	<u>\$ 728,410</u>

The Notes to the Financial Statements are an integral part of this statement.

Clean Water State Revolving Fund
Statements of Revenues, Expenses, and Changes in Net Assets
For the Years Ended June 30, 2010, and June 30, 2009

(Expressed in Thousands)

	Year Ended June 30, 2010	Year Ended June 30, 2009
OPERATING REVENUES		
Revenue from loans	\$ 15,087	\$ 14,179
Interest income	724	3,739
Total operating revenues	15,811	17,918
OPERATING EXPENSES		
Administrative expenses	1,049	960
Total operating expenses	1,049	960
Operating income	14,762	16,958
NONOPERATING REVENUE		
Operating grant	21,149	11,204
Total nonoperating revenue	21,149	11,204
NONOPERATING EXPENSE		
Principal forgiveness of ARRA Loans (Note 5)	5,609	-
Total nonoperating expense	5,609	-
Income before transfers	30,302	28,162
Transfers in (Note 4)	471	2,238
Change in net assets	30,773	30,400
Net assets, July 1	728,410	698,010
Net assets, June 30	\$ 759,183	\$ 728,410

The Notes to the Financial Statements are an integral part of this statement.

**Clean Water State Revolving Fund
Statements of Cash Flows
For the Years Ended June 30, 2010, and June 30, 2009**

(Expressed in Thousands)

	Year Ended June 30, 2010	Year Ended June 30, 2009
CASH FLOWS FROM OPERATING ACTIVITIES		
Payments for interfund services	\$ (1,049)	\$ (960)
Net cash used by operating activities	(1,049)	(960)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Operating grants received	21,149	11,204
Transfers in (Note 4)	471	2,238
Net cash provided by noncapital financing activities	21,620	13,442
CASH FLOWS FROM INVESTING ACTIVITIES		
Loans issued	(67,000)	(85,088)
Principal forgiven	(5,609)	-
Collections of loan principal	28,090	29,412
Security deposits from borrowers	334	519
Interest received on loans	14,979	14,186
Interest received on investments	739	3,796
Interest earnings repaid to borrowers	(59)	(145)
Net cash used by investing activities	(28,526)	(37,320)
Net increase (decrease) in cash	(7,955)	(24,838)
Cash, July 1	213,768	238,606
Cash, June 30	\$ 205,813	\$ 213,768
Reconciliation of operating income to net cash used by operating activities:		
Operating income	\$ 14,762	\$ 16,958
Adjustments to reconcile operating income to net cash used by operating activities:		
Revenue from loans	(15,087)	(14,179)
Interest income	(724)	(3,739)
Total adjustments	(15,811)	(17,918)
Net cash used by operating activities	\$ (1,049)	\$ (960)

The Notes to the Financial Statements are an integral part of this statement.

Clean Water State Revolving Fund
Notes to the Financial Statements
June 30, 2010, and June 30, 2009

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The Clean Water State Revolving Fund was created to provide local governments and utility districts with low-cost financial assistance to improve and protect water quality and public health.

Pursuant to the Governmental Accounting Standards Board's *Codification of Governmental Accounting and Financial Reporting Standards*, Section 2100, the Clean Water State Revolving Fund forms an integral part of state government and as such has been included in the *Tennessee Comprehensive Annual Financial Report* as an enterprise fund (Sewer Treatment Loan Fund).

Basis of Presentation

The accompanying financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB). The Clean Water State Revolving Fund follows all applicable GASB pronouncements as well as applicable private-sector pronouncements issued on or before November 30, 1989. The fund has chosen not to follow subsequent private-sector guidance.

Measurement Focus and Basis of Accounting

The accompanying financial statements have been prepared using the accrual basis of accounting and the flow of economic resources measurement focus. Under this method, revenues are recorded when earned, and expenses are recorded at the time liabilities are incurred.

Operating revenues and expenses are distinguished from nonoperating items in the Clean Water State Revolving Fund. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with principal ongoing operations. The principal operation of the fund is to provide loans to local governments through a revolving loan fund established under Title VI of the Clean Water Act. Therefore, the principal operating revenues of the fund are from interest on loans made to borrowers. The fund also recognizes interest income as operating revenue. The fund's operating expenses are its administrative expenses. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

Cash

This classification includes cash on hand and deposits in the pooled investment fund administered by the State Treasurer.

Clean Water State Revolving Fund
Notes to the Financial Statements (Cont.)
June 30, 2010, and June 30, 2009

NOTE 2. DEPOSITS

At June 30, 2010, the Clean Water State Revolving fund had \$201,479,567 in the State Treasurer's pooled investment fund for operating cash purposes, and \$4,333,384 in customer security deposits in the Local Government Investment Pool. At June 30, 2009, the fund had \$209,765,706 in the State Treasurer's pooled investment fund, and \$4,002,064 in the Local Government Investment Pool. The Local Government Investment Pool is part of the pooled investment fund administered by the State Treasurer. The pooled investment fund is authorized by statute to invest funds in accordance with policy guidelines approved by the State Funding Board. The fund is not rated by a nationally recognized statistical rating organization. Its investment policy and required risk disclosures are presented in the State of Tennessee's Treasurer's Report. The report is posted on the state's website at <http://www.treasury.tn.gov>, or a copy may be obtained by calling (615) 741-2956.

NOTE 3. PAYABLE TO BORROWERS

This account represents loan principal overpayments that will be refunded to borrowers and interest earned on security deposits, which per the loan agreements is due to the borrowers.

NOTE 4. INTERFUND TRANSFER

The Clean Water State Revolving Fund received an interfund transfer from the state's general fund to provide a state match for a federal grant to operate the program of \$471,195 during the year ended June 30, 2010, and \$2,237,636, during the year ended June 30, 2009.

NOTE 5. AMERICAN RECOVERY AND REINVESTMENT ACT (ARRA) OF 2009

The Clean Water State Revolving Fund received money from the ARRA Program for the fiscal year. The money was accepted by the Tennessee Department of Environment and Conservation, and they granted principal forgiveness to satisfy guidelines stipulated by the ARRA Act. Each community was limited to one CWSRF ARRA loan in an amount that could not exceed \$12.5 million dollars. Each community that applied for and accepted a loan received 40 percent principal forgiveness; thus only 60 percent of the total award was recorded as a repayable loan.