

AUDIT REPORT

Clean Water State Revolving Fund

For the Year Ended
June 30, 2011



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

Department of Audit
Division of State Audit



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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
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March 2, 2012

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, 2011. 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,

Arthur A. Hayes, Jr., CPA
Director

AAH/ddm
11/094

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, 2011

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 Again Did Not Comply with Federal Requirements of OMB Circular A-133, Section 400(d)*

The Department of Environment and Conservation did not ensure that all subrecipients of Capitalization Grants for Clean Water State Revolving Funds and Capitalization Grants for Drinking Water State Revolving Funds were monitored or received required audits.

* This finding is repeated from the prior audit.

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, 2011**

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Clean Water State Revolving Fund For the Year Ended June 30, 2011

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 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, 2010, through June 30, 2011, 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, 2011, and for comparative purposes, the year ended June 30, 2010. The Clean Water State Revolving Fund has been included as a component unit 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 FINDING

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The Department of Environment and Conservation

filed its report with the Department of Audit on November 23, 2011. A follow-up of the prior audit finding was conducted as a part of the current audit. The prior audit report contained a finding concerning subrecipient monitoring. That finding has not been resolved and is repeated in this 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 control 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, 2011, 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 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***

December 12, 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, 2011, and have issued our report thereon dated December 12, 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

Management of the Clean Water State Revolving Fund is responsible for establishing and maintaining effective 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 again did not comply with federal requirements of OMB Circular A-133, Section 400(d).

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

December 12, 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 again did not comply with federal requirements of OMB Circular A-133, Section 400(d)

Finding

As noted in the prior audit, management and staff of the Tennessee Department of Environment and Conservation (TDEC) did not comply with the federal requirements of the Office of Management and Budget (OMB) Circular A-133, Section 400(d), which defines the responsibilities of pass-through entities who pass federal grant funds to subrecipients. Our prior audit finding reported that TDEC failed to ensure compliance with the specific OMB A-133 requirements for:

- monitoring the activities of subrecipients,
- subrecipients' audits,
- issuing management decisions for subrecipients' audit findings, and
- notifying subrecipients of specific award information.

TDEC management concurred with the prior audit finding and stated, "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." In our current audit, we determined that management corrected the issues from the prior finding related to issuing management decisions for subrecipients' audit findings and notifying the subrecipients of specific award information. However, we found that the weaknesses related to subrecipients' monitoring and audit requirements were not corrected.

Background Information

The Environmental Protection Agency awarded capitalization grants to the state to create and maintain the Clean Water State Revolving Fund (CWSRF) and the Drinking Water State Revolving Fund (DWSRF) 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 with 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 wastewater authorities (subrecipients) with low-cost loans for the construction of wastewater 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 (TLDA). 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. Historically, in order to draw down federal reimbursement dollars sooner for the Clean Water State Revolving Fund projects, the SRFLP Manager has awarded federal loan funds to larger subrecipients who have multiple projects. 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. The SRFLP Manager 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. In our prior audit, the Program Manager stated that he did not notify subrecipients at either time whether the loan award included federal funds, but said he notified subrecipients when their loan agreements included federal dollars from the American Recovery and Reinvestment Act of 2009 (ARRA). In fiscal year 2011, to correct the previous finding, program management amended loan agreements for loans awarded after September 1, 2010, to notify subrecipients of the required award information. Also, staff who work in support of the Tennessee Local Development Authority send letters to subrecipients to disclose the amount of federal funds disbursed to the subrecipients.

Subrecipient Monitoring

In our prior audit, we reported that TDEC relied on its efforts to comply with the Department of Finance and Administration's Policy 22, *Subrecipient Contract Monitoring*, to ensure TDEC's subrecipients who received federal funding were monitored and to ensure TDEC management and staff met applicable federal compliance requirements. The state's Policy 22 specifically requires state department and agencies to address the compliance with OMB Circular A-133 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."

We noted in the prior audit finding that none of the CWSRF and DWSRF loan subrecipients were included in management's 2009 or 2010 federal fiscal year Policy 22 annual

monitoring plans because they were not properly identified as part of the subrecipient population. We also reported in the prior finding that those subrecipients were not monitored. In response to that finding, management specified that the 2011 federal fiscal year Policy 22 monitoring plan included all CWSRF and DWSRF subrecipients. Management also stated that all future Policy 22 monitoring plans would include all CWSRF and DWSRF subrecipients.

In the current audit, to determine whether TDEC management adequately identified all CWSRF and DWSRF subrecipients in its 2011 federal fiscal year Policy 22 population, we obtained a listing of all subrecipients who were issued CWSRF and DWSRF loan payments from TLDA staff and compared that listing to TDEC's subrecipient population. Based on our testwork, we found that 5 of 43 (12%) CWSRF and DWSRF subrecipients were not included in the federal fiscal year 2011 Policy 22 annual monitoring plan and, therefore, were not monitored as required by state and federal regulations. Even though TDEC management took steps to correct the prior finding, management still failed to include the subrecipients who only received non-ARRA federal funding through the CWSRF and/or DWSRF loan agreements. These five subrecipients were awarded federal loans and were reimbursed for expenses totaling \$5,124,617.18 in fiscal year 2011.

Although TDEC did not include these subrecipients in its formal monitoring efforts, we did determine that program 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, the inspections did not address specific program or OMB Circular A-133, Section 400(d) requirements.

Subrecipients' Audits

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."

Based on our interviews with the department's Director of Internal Audit and staff, to monitor subrecipients for OMB Circular A-133 audit requirements, the internal audit staff reviewed subrecipients' independent audit reports as part of their Policy 22 monitoring reviews and also obtained a separate listing of subrecipients from Edison, the state's accounting system, to ensure they had identified all subrecipients within the department.

However, for our audit period, we found that internal audit staff failed to identify 7 of 15 CWSRF and DWSRF subrecipients (47%) who had received federal funding above \$500,000 and thus required an audit based on fiscal year 2010 expenditures. As a result, internal audit staff did not ensure audits for these subrecipients were obtained.

Of the 15 CWSRF and DWSRF subrecipients, none were included in the 2010 federal fiscal year Policy 22 monitoring plan, as described above. Therefore, internal audit staff did not monitor any of the subrecipients as part of their 2010 federal fiscal year Policy 22 reviews. However, internal audit staff did monitor one subrecipient as part of a separate ARRA contract

process review. Internal audit staff also monitored five other subrecipients with their 2011 federal fiscal year Policy 22 reviews. Furthermore, an additional two subrecipients were identified on the Edison listing but only because these subrecipients had multiple contracts with TDEC. The Edison listing did not include subrecipients who only received CWSRF or DWSRF loan payments. The seven subrecipients internal audit failed to monitor were awarded federal loans and reimbursed for expenses totaling \$6,716,226.35.

When we notified internal audit staff of the omission of subrecipients, they immediately revised their procedures to include a separate step to obtain a list of CWSRF and DWSRF subrecipients from TLDA staff. However, internal audit staff did not implement the corrective action until after fiscal year 2011 had ended and after the deadline for the subrecipients to obtain an audit had passed.

Because we determined that management had not fulfilled their responsibilities under OMB A-133 for these seven CWSRF and DWSRF subrecipients, we expanded our testwork to determine if in fact the subrecipients had followed the OMB Circular A-133 requirements and had obtained an audit. We found the following:

- The City of Memphis, a CWSRF subrecipient since fiscal year 2010, received and expended \$2,561,049 in CWSRF loan funds for fiscal 2010 and failed to report these expenditures on the Schedule of Expenditures of Federal Awards (SEFA) or on its Data Collection Form for Reporting on Audits of States, Local Governments, and Non-Profit Organizations, the SF-SAC. As a result, their independent auditor did not know to audit these federal funds when in fact the level of CWSRF expenditures would have qualified CWSRF as a major program in 2010. Memphis was awarded two separate Clean Water fund loans totaling over \$9 million in state and federal funds for fiscal 2010 and 2011. After we notified internal audit staff of this omission, they sent Memphis a letter requesting corrective action. Memphis' independent auditor subsequently audited CWSRF as a major program. Memphis also corrected its SEFA and SF-SAC.
- Of the remaining 14 CWSRF and DWSRF subrecipients, 10 did not appropriately identify the amount of CWSRF/DWSRF expenditures on the SEFA and/or SF-SAC. One of these subrecipients also failed to correctly identify its two federal programs on its SEFA and SF-SAC.

Management's failure to follow state and federal requirements governing its responsibility as a pass-through entity increases the risks of noncompliance, fraud, waste and abuse within the federal programs. Given the problems we noted in our testwork, we also reviewed TDEC's most recent risk assessment. We determined that the department appropriately identified the risks included in this finding in its risk assessment, but adequate controls were not in place to prevent noncompliance.

Recommendation

The Commissioner of Environment and Conservation should require all employees who are responsible for federal grants to take immediate action to ensure compliance with all federal regulations. Management and staff should ensure controls are adequately established to mitigate risks of noncompliance, fraud, waste, and abuse within the federal programs. Specifically, management should ensure

- that all subrecipients who are required to be monitored under federal regulations are appropriately identified in the monitoring plans and are monitored;
- that all subrecipients receiving more than \$500,000 in federal funding, including all applicable CWSRF/DWSRF loans, annually obtain the required independent auditor's report; and
- that TDEC management communicates to all subrecipients the importance of accurate SEFA and SF-SAC reporting.

Management's Comment

We concur with Recommendations #2 and #3 and concur in part with Recommendation #1 as discussed below. Management and staff will continue to develop controls to mitigate the risks identified and ensure these controls are in place to comply with federal regulations to mitigate risks of fraud, waste and abuse. Risk assessments prepared for the year ended December 31, 2011, included the risks identified in this finding. Below are management's responses to each recommendation.

Recommendation #1: Management should ensure that all subrecipients who are required to be monitored under federal regulations are appropriately identified in the monitoring plans and are monitored.

We concur in part. The Comptroller's single audit included TDEC's Capitalization Grants for the Clean Water and Drinking Water State Revolving Fund programs. These programs' subrecipients represent only 15%¹ of TDEC's total population of subrecipient contracts for the federal fiscal year ended September 30, 2011. The audit report states "that 5 of 43² (12%) CWSRF and DWSRF subrecipients were not included in the federal fiscal year 2011 Policy 22 annual monitoring plan . . ." We agree that these 5 subrecipients were not included in our 2011 monitoring plan; however, it should be pointed out that these 5 subrecipients represent only 1.3% (5/388) of TDEC's total subrecipient population that TDEC is responsible for monitoring.

The 2011 Subrecipient Monitoring Plan was submitted to Finance and Administration (F&A) on September 30, 2010, and an amended plan was re-submitted to F&A in November

¹ CWSRF/DWSRF subrecipient contracts total 58 of TDEC's total subrecipient population of 388.

² Comptroller's total of 43 only includes CWSRF/DWSRF loan recipients receiving Federal Funds.

2010. The prior year Single Audit was issued March 29, 2011, four (4) months after the issuance of this plan. In TDEC's response to the prior year audit findings, management stated "All future submittals to F&A³ will include all the CWSRF and DWSRF loan recipients." TDEC management did not understand it was necessary to go back and make subsequent changes to the 2011 Subrecipient Monitoring Plan that was submitted prior to the March 29, 2011, Single Audit Report.

After discussions with the Comptroller auditors, TDEC staff has proactively revised the 2011 Subrecipient Monitoring Plan to include all subrecipients. We will continue to improve our internal controls so that future submittal of Subrecipient Monitoring Plans will include all subrecipients.

Recommendation #2: Management should ensure that all subrecipients receiving more than \$500,000 in federal funding, including all applicable CWSRF/DWSRF loans, annually obtain the required independent auditor's report.

We concur. Since the issuance of last year's Single Audit Report on March 29, 2011, TDEC management has been proactive in implementing policies and procedures to ensure our compliance with OMB A-133 audit requirements. This implementation process is a very involved process that requires interaction between TDEC divisions as well as interaction with the Tennessee Local Development Authority. Internal Audit staff has modified procedures to ensure that subrecipients receiving more than \$500,000 in federal funding annually obtain the required independent auditor's report.

Recommendation #3: Management should ensure that TDEC management communicates to all subrecipients the importance of accurate SEFA and SF-SAC reporting.

We concur. Management will ensure that subrecipients will receive communication from TDEC informing them of the importance of accurate SEFA and SF-SAC reporting.

³ The 2012 Subrecipient Monitoring Plan was submitted September 30, 2011.



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Independent Auditor's Report

December 12, 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, 2011, and June 30, 2010, 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 responsibilities to the Comptroller of the Treasury. Those responsibilities include serving as a member of the board of directors of the 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, 2011, and June 30, 2010, 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, 2011, and June 30, 2010, 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 December 12, 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 that reads "Arthur A. Hayes, Jr." The signature is written in a cursive style with a large, prominent initial "A".

Arthur A. Hayes, Jr., CPA
Director

AAH/ddm

Clean Water State Revolving Fund
Statements of Net Assets
June 30, 2011, and June 30, 2010

	June 30, 2011	June 30, 2010
(Expressed in Thousands)		
ASSETS		
Current assets:		
Cash (Note 2)	\$ 215,201	\$ 205,813
Receivables:		
Loans receivable	32,191	30,231
Interest receivable on loans	1	113
Total current assets	247,393	236,157
Noncurrent assets:		
Loans receivable	550,108	527,926
Total noncurrent assets	550,108	527,926
Total assets	797,501	764,083
LIABILITIES		
Current liabilities:		
Accounts payable	1,613	543
Payable to borrowers (Note 3)	14	24
Total current liabilities	1,627	567
Noncurrent liabilities:		
Customer deposits payable ((Note 2)	4,925	4,333
Total noncurrent liabilities	4,925	4,333
Total liabilities	6,552	4,900
NET ASSETS		
Unrestricted	790,949	759,183
Total net assets	\$ 790,949	\$ 759,183

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, 2011, and June 30, 2010

(Expressed in Thousands)

	Year Ended June 30, 2011	Year Ended June 30, 2010
OPERATING REVENUES		
Revenue from loans	\$ 15,494	\$ 15,087
Interest income	407	724
Total operating revenues	15,901	15,811
OPERATING EXPENSES		
Administrative expenses	1,041	1,049
Total operating expenses	1,041	1,049
Operating income	14,860	14,762
NONOPERATING REVENUE		
Operating grant	38,470	21,149
Total nonoperating revenue	38,470	21,149
NONOPERATING EXPENSE		
Principal forgiveness (Note 5)	28,454	5,609
Total nonoperating expense	28,454	5,609
Income before transfers	24,876	30,302
Transfers in (Note 4)	6,890	471
Change in net assets	31,766	30,773
Net assets, July 1	759,183	728,410
Net assets, June 30	\$ 790,949	\$ 759,183

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, 2011, and June 30, 2010

(Expressed in Thousands)

	Year Ended June 30, 2011	Year Ended June 30, 2010
CASH FLOWS FROM OPERATING ACTIVITIES		
Payments for interfund services	\$ (1,041)	\$ (1,049)
Net cash used by operating activities	(1,041)	(1,049)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Operating grants received	38,470	21,149
Transfers in	6,890	471
Net cash provided by noncapital financing activities	45,360	21,620
CASH FLOWS FROM INVESTING ACTIVITIES		
Loans issued	(59,618)	(67,000)
Principal forgiven	(28,121)	(5,609)
Collections of loan principal	36,214	28,090
Security deposits from borrowers	591	334
Interest received on loans	15,600	14,979
Interest received on investments	418	739
Interest earnings repaid to borrowers	(15)	(59)
Net cash used by investing activities	(34,931)	(28,526)
Net increase (decrease) in cash	9,388	(7,955)
Cash, July 1	205,813	213,768
Cash, June 30	\$ 215,201	\$ 205,813
Reconciliation of operating income to net cash used by operating activities:		
Operating income	\$ 14,860	\$ 14,762
Adjustments to reconcile operating income to net cash used by operating activities:		
Revenue from loans	(15,494)	(15,087)
Interest income	(407)	(724)
Total adjustments	(15,901)	(15,811)
Net cash used by operating activities	\$ (1,041)	\$ (1,049)

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, 2011, and June 30, 2010

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, 2011, and June 30, 2010

NOTE 2. DEPOSITS

At June 30, 2011, the Clean Water State Revolving Fund had \$210,276,325 in the State Treasurer's pooled investment fund for operating cash purposes and \$4,924,888 in customer security deposits in the Local Government Investment Pool. At June 30, 2010, the fund had \$201,479,567 in the State Treasurer's pooled investment fund and \$4,333,384 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 a interfund transfer from the state's general fund to provide a state match for a federal grant to operate the program of \$6,889,530 during the year ended June 30, 2011, and \$471,195 during the year ended June 30, 2010.

NOTE 5. PRINCIPAL FORGIVENESS

In fiscal year 2010, the Clean Water State Revolving Fund received money from the American Recovery and Reinvestment Act of 2009 (ARRA). As part of the conditions stipulated by the Act for acceptance of this money, the State Revolving Fund program granted principal forgiveness to the borrowers. Each community that received an ARRA loan was granted forty percent principal forgiveness, thus only sixty percent of the total award was recorded as a repayable loan. Additionally, each community was limited to one CWSRF ARRA loan in an amount that could not exceed \$12.5 million dollars.

In fiscal year 2011, the capitalization grant received by the Clean Water State Revolving Fund also stipulated that the state must subsidize a portion of the borrower loans. Therefore, for the first time as a part of its normal operations, the

Clean Water State Revolving Fund
Notes to the Financial Statements (Cont.)
June 30, 2011, and June 30, 2010

fund began granting principal forgiveness as a part of the loans made from the capitalization grant. The communities to receive this subsidization are determined according to normal procedures of priority ranking used in the past to make loans.