



U.S. ENVIRONMENTAL PROTECTION AGENCY  
OFFICE OF INSPECTOR GENERAL

*Catalyst for Improving the Environment*

## Audit Report

# EPA and States Should Strengthen Oversight of Clean Water State Revolving Fund Recovery Act Projects

Report No. 11-R-0519

August 24, 2011



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## Abbreviations

ARRA	American Recovery and Reinvestment Act of 2009
CWA	Clean Water Act
CWSRF	Clean Water State Revolving Fund
EPA	U.S. Environmental Protection Agency
FMFIA	Federal Managers' Financial Integrity Act
FY	Fiscal year
GAO	U.S. Government Accountability Office
OA	Operating agreement
OIG	Office of Inspector General
OMB	Office of Management and Budget
OW	Office of Water
PER	Program evaluation report

**Cover photos:** *From left:* Newly constructed chlorine contact chamber at an ARRA clean water project site; pipe in staging area at an ARRA clean water project site. (EPA OIG photos)

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# At a Glance

*Catalyst for Improving the Environment*

## Why We Did This Review

We conducted this audit to determine whether the U.S. Environmental Protection Agency (EPA) and selected states are sufficiently overseeing Clean Water State Revolving Fund (CWSRF) projects that were funded by the American Recovery and Reinvestment Act of 2009 (ARRA), to ensure that project goals and ARRA requirements are met.

## Background

The CWSRF Program received \$4 billion of ARRA funding for states to finance high-priority infrastructure projects needed to ensure clean water. EPA made ARRA grants to states and Puerto Rico to capitalize their State Revolving Fund programs to finance eligible high-priority water infrastructure projects.

For further information, contact our Office of Congressional, Public Affairs and Management at (202) 566-2391.

The full report is at:  
[www.epa.gov/oig/reports/2011/20110824-11-R-0519.pdf](http://www.epa.gov/oig/reports/2011/20110824-11-R-0519.pdf)

## ***EPA and States Should Strengthen Oversight of Clean Water State Revolving Fund Recovery Act Projects***

### **What We Found**

State oversight of CWSRF projects does not always ensure subrecipient compliance with ARRA. We found that some states were not conducting adequate oversight of subrecipient compliance with the Buy American provisions of ARRA, and the frequency of inspections of ARRA-funded CWSRF projects varied among states. EPA oversight guidance to the states is not detailed enough to ensure compliance with ARRA requirements. EPA believes that it lacks statutory authority to place requirements on states and gives states flexibility to implement their programs. However, if states do not conduct proper oversight, projects are at increased risk of fraud, waste, and abuse, and are also at risk for not complying with ARRA requirements or achieving ARRA's economic recovery goals.

EPA's oversight of states does not ensure that ARRA requirements are met on CWSRF projects. We found that the ARRA inspection checklist does not include enough detailed questions to facilitate EPA oversight of state programs. Further, the Office of Water is not conducting and documenting reviews of state programs in a timely manner and does not use the resulting review reports to make national program decisions. Office of Water management did not make completion of the review reports a priority and did not use all of the ARRA funding Congress allocated for oversight. As a result, the EPA oversight process cannot ensure that states are complying with program requirements and identifying nationwide issues to improve the CWSRF program.

### **What We Recommend**

We recommend that EPA implement a plan to supplement state inspections and require states to use an updated checklist during their inspections. We recommend that EPA update the checklists regions use for semiannual reviews of state programs and establish deadlines for completing the reviews. We also recommend that EPA analyze the reviews of state programs for nationwide trends and use the information to assist in making future program decisions. In responding to the draft report, EPA did not agree with all of our recommendations and provided alternative corrective actions for some. The Agency did not provide planned completion dates for the recommendations. For this reason, the recommendations are unresolved. In responding to the final report, the Agency will need to provide a corrective action plan and milestone dates for completion.



UNITED STATES ENVIRONMENTAL PROTECTION AGENCY  
WASHINGTON, D.C. 20460

THE INSPECTOR GENERAL

August 24, 2011

**MEMORANDUM**

**SUBJECT:** EPA and States Should Strengthen Oversight of  
Clean Water State Revolving Fund Recovery Act Projects  
Report No. 11-R-0519

**FROM:** Arthur A. Elkins Jr.  
Inspector General

A handwritten signature in black ink, appearing to read "Arthur A. Elkins Jr.", is written over the printed name of the Inspector General.

**TO:** Nancy Stoner  
Acting Assistant Administrator for Water

This is the final report on the subject audit conducted by the Office of Inspector General (OIG) of the U.S. Environmental Protection Agency (EPA). This report contains findings that describe the problems the OIG has identified and corrective actions the OIG recommends. This report represents the opinion of the OIG and does not necessarily represent the final EPA position. Final determinations on matters in this report will be made by EPA managers in accordance with established audit resolution procedures.

The estimated direct labor and travel costs for this report are \$499,342.

**Action Required**

In accordance with EPA Manual 2750, you are required to provide a written response to this report within 90 calendar days of the report date. In responding to the draft report, the Agency did not provide planned completion dates for the proposed recommendations. For this reason, the recommendations are unresolved. In responding to the final report, the Agency will need to provide a corrective action plan and milestone dates for completion. Your response will be posted on the OIG's public website, along with our memorandum commenting on your response. Your response should be provided as an Adobe PDF file that complies with the accessibility requirements of Section 508 of the Rehabilitation Act of 1973, as amended. The final response should not contain data that you do not want released to the public; if your response contains such data, you should identify the data for redaction or removal. We have no objections to the further release of this report to the public. We will post this report to our website at <http://www.epa.gov/oig>.

If you or your staff has any questions regarding this report, please contact Melissa Heist, Assistant Inspector General for Audit, at (202) 566-0899 or [heist.melissa@epa.gov](mailto:heist.melissa@epa.gov); or Janet Kasper, Director of Contracts and Assistance Agreement Audits, at (312) 886-3059 or [kasper.janet@epa.gov](mailto:kasper.janet@epa.gov).

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# Chapter 1

## Introduction

### Purpose

The American Recovery and Reinvestment Act of 2009 (ARRA) provides that the Office of Inspector General (OIG) should oversee ARRA funds to ensure that they are properly expended in a transparent manner. Of all U.S. Environmental Protection Agency (EPA) programs to receive ARRA funds, the Clean Water State Revolving Fund (CWSRF) Program received the most funding. We sought to determine whether EPA and states<sup>1</sup> performed sufficient oversight of ARRA CWSRF projects to ensure that project goals and ARRA requirements were met.

### Background

#### **ARRA**

The purpose of ARRA, in part, was to create and save jobs, jumpstart the economy, and build the foundation for long-term economic growth. ARRA provided EPA with \$7.2 billion, including \$4 billion for the CWSRF Program. ARRA required agencies to award the funding consistent with prudent management and Office of Management and Budget (OMB) ARRA guidance. This guidance required agencies to initiate additional oversight mechanisms to mitigate ARRA's "unique implementation risks."

New requirements and specific guidelines apply to grants made with ARRA funds. For example, contractors that receive CWSRF ARRA funds are required to pay all laborers and mechanics at or above the prevailing Davis-Bacon Act wage rates determined by the Secretary of Labor. Additionally, and with a few exceptions, subrecipients are required to use only American-made iron, steel, and other manufactured goods under the Buy American provisions of ARRA.

#### **CWSRF Program**

The Clean Water Act (CWA), as amended in 1987, established a water pollution revolving fund that has evolved into today's CWSRF Program. Through the CWSRF, EPA provides states with annual capitalization grants to fund water quality protection projects for wastewater treatment, nonpoint source pollution control, and watershed and estuary management. The grants are awarded to states to develop a conservation plan, implement a management program, and issue loans to local communities to construct treatment works. States have the flexibility to target resources to their particular environmental needs.

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<sup>1</sup> "States" refers to either states or U.S. territories that received CWSRF ARRA funding.

The CWA requires EPA to provide oversight for state programs to ensure compliance with the CWA and EPA guidance. EPA must approve annual project funding plans, conduct reviews, and provide consultation and technical assistance, as necessary. The CWA also requires EPA to inform states of noncompliance issues identified in reviews and to propose corrective action.

### ***State Oversight***

The CWA allows states to use up to 4 percent of CWSRF ARRA funds appropriated for management and oversight purposes. EPA-state operating agreements (OAs) require states to:

- Manage the CWSRF Program in accordance with the OA and terms of the grant agreement, and in conformance with applicable state and federal laws, regulations, and guidance
- Maintain a competent organization and a staff-skill mix to assure that projects meet acceptable technical, environmental, and financial requirements as established or referenced in the OA

Annual capitalization grant agreements require states to maintain primary responsibility for ensuring successful completion of EPA-approved projects. Agreements also require states to monitor the performance of subrecipients to ensure that they comply with all applicable regulations, statutes, and terms and conditions for each project.

In March 2010, EPA provided ARRA-specific oversight guidance to states. The guidance included an optional ARRA inspection checklist for states to use. This checklist instructed states to confirm that ARRA-funded projects comply with the Davis-Bacon Act and Buy American provisions. EPA also encouraged states to inspect each project at least once per year.

### ***Subrecipient Responsibilities***

Subrecipients are responsible for ensuring that projects comply with federal laws and regulations. EPA-state capitalization grant agreements stipulate that states must require subrecipients to complete and report on projects to ensure they comply with ARRA requirements. Subrecipients must comply with ARRA Buy American provisions or follow the EPA waiver processes for exemptions. Subrecipients must also maintain payroll records that comply with ARRA Davis-Bacon provisions. Subrecipients must maintain records that adequately identify the source and application of ARRA funds. States convey these requirements to subrecipients through loan agreements.

In its 2010 *Report to the Nations on Occupational Fraud and Abuse*, the Association of Certified Fraud Examiners ranked the construction industry 9th out of 22 industries for risk of occupational fraud, both in terms of frequency of fraud cases and median loss. Notably, the construction industry had the fourth-highest percentage of corruption cases in the fraud association study. These statistics illustrate the importance of robust subrecipient monitoring and oversight of CWSRF ARRA-funded construction projects.

## **Noteworthy Achievements**

EPA took steps to assist recipients and subrecipients in complying with newly introduced ARRA requirements. Specifically, EPA hosted webcasts for states and subrecipients that provided guidance on monitoring compliance with Davis-Bacon and Buy American provisions. EPA's Office of Water (OW) offered contractor assistance to regions and states to conduct inspections and review project documentation. Representatives from at least six EPA regions accompanied OIG staff to give ARRA fraud, waste, and abuse briefings to states, subrecipients, and contractors.

Four of the five states we visited (Hawaii, Oregon, Puerto Rico, and Texas) incorporated unannounced inspections as part of their routine oversight. We view this as a best practice, because such inspections more readily identified and corrected instances of ARRA noncompliance. In addition, three other states (Illinois, Minnesota, and Wisconsin) created their own review documents for monitoring subrecipient compliance with ARRA requirements.

## **Scope and Methodology**

We conducted this performance audit from February 2010 to April 2011 in accordance with generally accepted government auditing standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

We reviewed relevant federal regulations and guidance. We interviewed EPA headquarters and regional CWSRF staff (Regions 2, 6, 9, and 10) regarding how EPA ensures that ARRA CWSRF projects meet intended project goals and ARRA requirements. We selected states and project sites based on a risk assessment that factored in past single audit and annual financial report findings, as well as an analysis of state financial management of CWSRF programs. We visited state offices and interviewed staff in Hawaii, New Jersey, Oregon, Puerto Rico, and Texas. We also visited construction sites in Oregon and Puerto Rico. We surveyed additional states and EPA regions to increase our audit coverage. Overall, we visited or surveyed 13 out of the 51 CWSRF-eligible states/territories and 9 out of

10 EPA regions. See appendix A for further details on our scope and methodology.

**Prior Audit Coverage**

**EPA OIG**

In OIG Report No. 08-P-0290, *Innovative Techniques for State Monitoring of Revolving Funds Noted*, September 29, 2009, the OIG suggested that EPA include a review of how states monitor borrowers as part of its annual review procedures. Because this report contained no recommendations, EPA was not required to respond.

In OIG Report No.10-3-0223, *City of Detroit, Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2009*, May 28, 2010, the OIG reported that for some ARRA-funded projects, the Buy American certifications were not maintained, and the Davis-Bacon Act requirements were not verified, because the subrecipient, a local government, did not communicate the ARRA requirements to the construction contractor.

In addition, the OIG conducted unannounced site visits of ARRA projects to determine compliance with selected requirements of ARRA. As of April 2011, the OIG issued seven reports on site visits to CWSRF projects, as shown in table 1.

**Table 1: EPA OIG reports on site visits to CWSRF ARRA projects**

Report Title	Number	Date
American Recovery and Reinvestment Act Site Inspection of the High-Rate Water Treatment Facility, City of Newark, Ohio	10-R-0147	June 16, 2010
American Recovery and Reinvestment Act Site Inspection of Sewer Pump Station Rehabilitation and Improvements, Town of Ball, Louisiana	11-R-0014	November 9, 2010
American Recovery and Reinvestment Act Site Inspection of the Clean Water State Revolving Fund Projects at the City of Long Beach, California	11-R-0082	February 1, 2011
American Recovery and Reinvestment Act Site Inspection of Sewer System Improvement Projects, City of Parma, Ohio	11-R-0083	February 2, 2011
American Recovery and Reinvestment Act Site Visit of the Denver Street Storage Project, City of Astoria, Oregon	11-R-0172	March 22, 2011
American Recovery and Reinvestment Act Site Visit of Water System Improvement Project, Waleska, Georgia	11-R-0193	March 29,2011
American Recovery and Reinvestment Act Site Visit of the Comprehensive Sewer System Rehabilitation, Subsystem PS-5, Saugus, Massachusetts	11-R-0192	March 29,2011

Source: EPA OIG.

## U.S. Government Accountability Office

The U.S. Government Accountability Office (GAO) issued GAO-10-604, *States' and Localities' Uses of [ARRA] Funds and Actions Needed to Address Implementation Challenges and Bolster Accountability*, in May 2010. This report presented GAO's conclusions and recommendations on agencies' accountability regarding the use of ARRA funds based on a sample of 16 states, numerous localities, and agencies' Washington, DC, operations. GAO recommended that EPA "work with the states to implement specific oversight procedures to monitor and ensure subrecipients' compliance" with ARRA CWSRF requirements. In response, EPA stated that it enhanced subrecipient oversight ". . . through procedures designed to address EPA review of State ARRA programs and the frequency, content, and outputs of EPA and State reviews of specific ARRA projects." These procedures were designed to:

- Continue to conduct ARRA reviews of each state on a semiannual basis
- Develop the optional state inspection checklist for subrecipient monitoring
- Encourage states to inspect all ARRA projects at least once a year and require EPA to participate in at least one project site inspection per year with each state
- Continue to conduct webcasts for states and subrecipients on ARRA-specific provisions
- Continue to provide technical assistance as needed

## **Chapter 2**

# **States Should Strengthen Oversight of CWSRF Projects**

State oversight of CWSRF projects does not always ensure subrecipient compliance with ARRA. We found that some states were not ensuring compliance with the Buy American provisions of ARRA, and states were not using the optional administrative funds set-aside that is available to perform oversight. We also found that more frequent inspections are likely to result in identifying more violations. EPA oversight guidance to the states is not sufficiently detailed to ensure compliance with ARRA requirements. EPA believes that it lacks statutory authority to place requirements on states and wants to afford states flexibility in implementing their programs. However, if states do not properly oversee projects, projects are at risk of not achieving ARRA goals or not complying with ARRA requirements, and have an increased risk of fraud, waste, and abuse.

### **States Required to Oversee ARRA Projects**

The OAs between EPA and states require states to maintain a competent organization and a staff-skill mix to assure that projects meet acceptable technical, environmental, and financial requirements. The state capitalization grant agreements we reviewed require states to ensure that subrecipients comply with ARRA requirements.

OMB's ARRA oversight guidance emphasizes that the ARRA recipient, which in this case is the state, is responsible for ensuring that all ARRA requirements are met. EPA gave states the option to use an ARRA inspection checklist to confirm that projects are in compliance with the Davis-Bacon Act and Buy American provisions of ARRA. EPA guidance also encouraged states to perform at least one inspection per year.

### **States Should Strengthen Oversight of Subrecipients**

We found that state oversight did not always ensure subrecipient compliance with all ARRA provisions. One state did not verify that documents the subrecipients submitted as evidence actually demonstrated compliance with ARRA requirements. States were more likely to identify compliance issues when they conducted more frequent inspections. Some states were also not using all funds available to oversee ARRA projects.

## ***States Not Ensuring Compliance with Certain ARRA Provisions***

We visited five states. Three of those states do not independently verify compliance with ARRA requirements.<sup>2</sup> We visited five projects in two of those three states and reviewed subrecipient documentation. EPA developed an ARRA checklist that states can follow to ensure compliance with requirements; however, states were not required to use the checklist, and the checklist did not require verification to source documentation of ARRA requirements. One state we visited developed its own ARRA checklist, while two other states were adopting EPA's ARRA checklist. The checklist suggested that states confirm compliance with Buy American requirements; it did not require states to confirm that subrecipients verified that the documentation complied with ARRA requirements. For Davis-Bacon Act wage requirements, the EPA checklist only requires states to confirm that the subrecipient was verifying compliance. States were not asked to perform an independent assessment of the records. Two states we visited voluntarily made it a practice to verify documentation.

We found that 40 of 54 Buy American certifications for the five projects we reviewed did not include sufficient information (as defined by EPA guidance) to verify compliance. For example, in one instance the subrecipient accepted the supplier's statement that materials made in Canada automatically complied with ARRA, when in fact, materials produced in Canada are not allowable purchases under the ARRA Buy American provision unless EPA grants a waiver. In other instances, the documentation that the subrecipient accepted from suppliers was missing key information such as the name of the ARRA-funded project, detailed responses to the substantial transformation questionnaire, a description of complex and meaningful processes that caused a substantial transformation, or the location where the substantial transformation occurred.

EPA said that the subrecipients are responsible for ensuring compliance with the Buy American provisions of ARRA. The loan agreements between the state and subrecipient included a requirement that the state ensure compliance with all applicable regulations, with specific reference to ARRA requirements. The states we reviewed accepted documentation from subrecipients without verification of compliance. While the states said that it was the responsibility of the subrecipient to monitor compliance, the grant agreement identifies monitoring compliance with applicable laws and regulations as a state responsibility and does not mention whether the state can delegate the responsibility.

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<sup>2</sup> Since the OIG on-site review, Puerto Rico has instituted a new Buy American review process for subrecipient compliance.

### ***More Frequent Inspections Likely to Identify More Violations***

States had varying approaches to CWSRF construction project oversight. Some states conduct inspections based on a percentage of project completion, while others have biweekly, monthly, or quarterly inspections, as shown in table 2.

**Table 2: ARRA-funded project inspection frequency by state**

<b>State</b>	<b>Biweekly</b>	<b>Monthly</b>	<b>Quarterly</b>	<b>% completed</b>
California				X
Georgia		X		
Hawaii			X	
Indiana				X
Iowa				X
New Hampshire		X		
New Jersey			X	
North Dakota			X	
Oregon				X
Pennsylvania				X
Puerto Rico	X			
Texas		X		
West Virginia		X		

Source: State responses to OIG survey and interviews.

States that conducted more frequent project inspections identified more issues related to noncompliance with ARRA requirements, as noted in table 3. For example one state that conducted more frequent (i.e., monthly) inspections identified goods being used on the sites that did not meet Buy American requirements. Another state found noncompliance with Buy American requirements at its quarterly site visits and, as a result, increased its use of unannounced site visits. In contrast, another state that conducted inspections when a project was 30, 50, and 90 percent complete (which is less frequently than other states) did not identify any noncompliance issues. While the evidence we obtained suggests that the greater the frequency of inspections the more violations are likely to be found, we recognize other factors also contribute to the identification of violations. As EPA stated in its response to our draft report, the degree to which subrecipients understand requirements and are willing to ensure compliance and technical and managerial competency are contributing factors.

**Table 3: State inspection frequency and violation identified**

State	Frequency of inspection	Types of violations identified by state
Hawaii	Quarterly, unannounced	<ul style="list-style-type: none"><li>• Material on project site not compliant with Buy American requirement</li></ul>
New Jersey	Quarterly, unannounced	<ul style="list-style-type: none"><li>• Incorrect ARRA signage</li><li>• Noncompliance with Davis - Bacon requirements</li></ul>
Puerto Rico	Biweekly	<ul style="list-style-type: none"><li>• Safety violations</li><li>• Environmental violations</li></ul>
Texas	Monthly, unannounced	<ul style="list-style-type: none"><li>• Material not compliant with Buy American requirement</li><li>• Insufficient Davis-Bacon documentation and ARRA signage on-site</li></ul>
Oregon	Project 30, 50, and 90% complete	None

Source: State inspection reports and interviews with state staff.

EPA maintains that it does not have the statutory authority to stipulate the number or frequency of state inspections of projects. EPA also maintains that it gave states flexibility in overseeing projects and, along with the states we visited, places heavy reliance on subrecipients to ensure compliance with ARRA provisions. According to EPA management, when Congress created the CWSRF Program, it intended for states to have flexibility in implementing their programs. However, the OIG has concluded that, taken together, CWA, ARRA, and OMB guidance provide EPA with the authority to require additional state oversight.

### ***States Not Using Administrative Set-Aside***

Six of the 13 states that we surveyed were not using any of their administrative set-aside funds, as shown in table 4. The CWA allows states to use up to 4 percent of the capitalization grant to administer the program. Four states did not use any of their set-aside funds for administrative purposes. Instead, they applied all of the funds either to projects or to community financial assistance. One state said it did not need the administrative set-aside funds because it already assesses a 0.05 percent annual fee on the unpaid balance on each loan to support administration of the CWSRF loan program. One state indicated that resource limitations did not allow it to review ARRA applications in a timely manner. However, this state did not use its administrative set-aside.

**Table 4: State set-aside use as of July 30, 2010**

State	State set-aside used
California	X
Georgia	X
Hawaii	X
Indiana	
Iowa	
New Hampshire	X
New Jersey	
North Dakota	X
Oregon	
Pennsylvania	
Puerto Rico	X
Texas	X
West Virginia	

Source: State responses to OIG survey.

## Conclusion

States should regularly monitor projects to ensure compliance with ARRA requirements. Regions collect information on state capacity to implement the programs during semiannual program evaluation reviews. These reviews are discussed in detail in chapter 3. Our review, while limited in scope, found instances of potential noncompliance with Buy American requirements. Without oversight, risk of fraud, waste, and abuse involving government funds increases, and projects are at risk for not achieving ARRA goals. When states do not perform sufficient oversight, EPA does not have accurate information on compliance with ARRA requirements.

A recent single audit report and an EPA study of grant recipients also support the need for improved state oversight. The 2010 single audit report for the state of Michigan found that for some ARRA-funded projects, the Buy American certifications were not maintained, and the Davis-Bacon Act requirements were not verified, because the subrecipient, a local government, did not communicate the ARRA requirements to the construction contractor. EPA, in a June 2010 study, also identified local governments—the primary subrecipients for CWSRF funds—as a recipient category that is at high risk for fund mismanagement and appears to have the highest dollar amount at risk for unallowable costs.

## Recommendations

We recommend that the Assistant Administrator for Water:

1. Develop and implement a plan to supplement the state inspections with EPA inspections of ARRA projects that includes expanded testing to verify compliance with ARRA requirements.
2. Require states to follow the updated state ARRA inspection checklist and reference guide when inspecting ARRA projects.

## Agency Response and OIG Comment

OW did not concur with the first recommendation as it was written in the draft report. The recommendation was for EPA to ensure that states conduct adequate oversight of subrecipients, including requiring, as needed, that states develop corrective action plans that address the frequency of inspections. OW explained that site inspection is only one of many approaches to reduce noncompliance, and only mitigates the risk in the very few instances of willful and knowing noncompliance. Prudent management requires EPA to consider the nature, effect, and available options for resolving noncompliance when evaluating the needed frequency of inspections. Through conducting reviews of state programs and on-site inspections in accordance with the regional oversight management plan, OW has been able to determine which states need to do a better job of inspecting projects under ARRA. In addition, EPA will be independently inspecting up to 30% of all CWSRF ARRA projects during the remainder of the calendar year 2011.

The OIG evaluated OW's plan to inspect ARRA projects to determine whether it would address the issues in the finding and meet the intent of the recommendation. The statement of work does require expanded testing for compliance with ARRA requirements. The inspection checklist and guidance for the contractor inspections does include steps to verify compliance with ARRA requirements.

EPA conducting the inspections instead of states will not ensure that in the long-term states are providing adequate oversight of SRF projects. It would have been beneficial if EPA chose the sites based on the results of state reviews and focused on states that may not have been doing a good job at conducting inspections. However, given that ARRA was a one-time funding source, and the sites to be inspected have already been selected, the OIG will accept the additional inspections as adequate corrective action. In responding to the final report, OW should include an estimate of the minimum number of inspections that will be done and a milestone date for completing the inspections.

OW did not agree with our original second recommendation to require states to test and verify that subrecipient documentation complies with ARRA

requirements. Beyond the question of whether EPA possesses the legal authority to impose the recommended requirement, OW stated that virtually all states are already inspecting projects, and many are using or incorporating specific elements from the inspection checklist developed by the program.

On the issue of legal authority, the OIG came to the conclusion that EPA had the authority to require additional reviews based its review of the CWA, ARRA, and OMB guidance. The CWA provides EPA with the authority to require audits and reviews “as may be deemed necessary or appropriate . . . to carry out the objectives of this section.” This language does not establish a set number or set circumstances under which additional audits or reviews would be necessary, but it does provide discretion for the Administrator to direct additional reviews or audits when necessary or appropriate. OMB guidance<sup>3</sup> establishes that “[a]gencies must take steps, beyond standard practice, to initiate additional oversight mechanisms.” The OMB guidance specifically contemplates mandatory field visits or additional case examinations to ensure compliance with grant rules and regulations.

In discussing the response to the draft report, OW provided additional information on revisions to the inspection checklist and reference guide that will address the report finding if states are required to follow them. In preparation for the additional site inspections, EPA updated the state ARRA inspection checklist and included a reference guide that has additional details as to what state personnel should review in conducting the inspections. The revised checklist and reference guide, taken together, require testing and verification of subrecipient documentation. If EPA were to require the states to use the revised ARRA inspection checklist and reference guide in conducting site inspections, it would address the findings in this chapter. We revised recommendation 2 to reflect this alternative action. In responding to the final report, EPA should provide a plan and milestone date for issuing the updated state ARRA inspection checklist and reference guide to states.

In responding to the draft report, the Agency did not provide planned completion dates for the proposed recommendations. For this reason, the recommendations are unresolved. In responding to the final report, the Agency will need to provide a corrective action plan and milestone dates for completion.

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<sup>3</sup> OMB, *Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009*, M-09-15, 2009, Section 5.4.

## Chapter 3

### EPA Should Strengthen Oversight of States

EPA's oversight of states does not ensure that ARRA requirements are met on CWSRF projects. We found that the EPA review checklist does not include sufficiently detailed questions to facilitate EPA oversight of state programs. Further, OW is not timely conducting and reporting on the results of its reviews of state programs and does not use the review reports to make national program decisions. The CWA and the OAs require EPA to provide technical assistance and oversight of state programs. The conditions we found exist because OW management did not make completion of the review reports a priority and did not use all of the oversight resources available from the ARRA funding. EPA did not identify untimely completion of the review reports as a risk that ARRA program goals are not being met and that funds are not used appropriately. As a result, the EPA oversight process cannot ensure that states are complying with program requirements and identifying nationwide issues to improve the CWSRF program.

#### EPA Required to Oversee State Programs

The CWA requires EPA to conduct an annual review of each State Revolving Fund program. The OAs between EPA and the states establish, in general terms, the roles and responsibilities of EPA and the states for the CWSRF Program. The OAs generally require EPA, through the regions, to provide technical assistance, advice, and consultation to the state; and to provide oversight through the annual review process. The regions document their annual reviews of state programs in a program evaluation report (PER).

GAO recommended in May 2010 that the EPA Administrator work with the states to implement specific oversight procedures to monitor and ensure subrecipients' compliance with the provisions of the ARRA-funded State Revolving Fund programs. EPA implemented various actions that addressed GAO's recommendation. For example, EPA increased the frequency of regional reviews of states from annual to semiannual. EPA also increased its sampling of project files and transaction testing from two to four per review.

#### EPA Should Strengthen Oversight of State Programs

##### *EPA's Review Checklist Did Not Ensure State Program Compliance*

OW provided the regions with guidance for conducting semiannual ARRA reviews of the state CWSRF programs. In conducting the semiannual reviews, OW instructed the regions to use an EPA-created ARRA checklist to assist in the

completion of the PERs. The EPA semiannual ARRA review checklist includes review of:

- Eligibility of projects
- State program staff capacity and use of funds
- Federal cross-cutting authorities
- Environmental review requirements
- States' receipt and maintenance of documentation related to ARRA requirements: Section 1512 reporting, green project reserve, Davis-Bacon, Buy American
- Supporting documentation for four projects
- Four cash draws of EPA funds

EPA's semiannual ARRA review checklist did not include sufficiently detailed questions to ensure state program compliance. For example, it does not include:

- Detailed questions about state oversight of project construction
- Detailed questions about Davis-Bacon and Buy American documentation review or a recommendation to spot-check to verify compliance
- Expanded transaction testing when erroneous payments are identified

Based on our review of the PERs, adding the important aspects listed above into EPA's review checklist would strengthen EPA's oversight process and increase EPA's ability to identify noncompliance. In 2011, EPA will continue to conduct semiannual reviews of states using the current ARRA checklist.

### ***EPA Not Timely Conducting and Writing Reviews of State Programs***

EPA OW management did not establish as a priority the writing of regional semiannual ARRA state program reviews in a timely manner. Although OW management provided guidance requiring reviews to be completed semiannually, it did not establish a timeframe or deadline for the PERs to be written. Similarly, EPA regions did not establish as a priority the documenting of regional semiannual ARRA reviews of state programs in a timely manner.

EPA did not timely conduct and document the semiannual ARRA reviews of the state programs. As of September 30, 2010, only 4 of 10 regions had conducted the two reviews for the year, required by EPA ARRA program guidance. The remaining regions had a portion of reviews conducted or a portion of reports written, as shown in table 5.

**Table 5: Status of regional reviews and PERs as of September 30, 2010**

Region	Number of states	Required number of reviews	Reviews conducted	Reports completed
1	6	12	11	3
2	3	6	4	1
3	5	10	10	5
4	8	16	9	5
5	6	12	12	5
6	5	10	10	4
7	4	8	7	4
8	6	12	11	5
9	4	8	7	3
10	4	8	8	1
<b>Total</b>	<b>51</b>	<b>102</b>	<b>89</b>	<b>36</b>

Source: Status of PERs provided by EPA regions and headquarters as of September 30, 2010.

A region may take several months to write the final PER. On average, 3.7 months elapsed from when the review was conducted to when the PER was finalized, with the longest elapsed time being 9.8 months (see appendix B for details). A written product summarizing what the region found during the review is important. First, the PER serves as evidence of EPA's oversight. Second, it serves as a written record of weaknesses and as the basis for developing corrective action plans. Third, EPA could use the written products to identify trends in state management of ARRA funds.

### ***EPA Not Using PERs to Make Agency Program Decisions***

EPA did not use the PERs collectively to make Agency decisions to improve the program. Currently, EPA uses PERs solely to identify and correct deficiencies in program management of individual states. Because EPA is not analyzing the PER results to identify national trends in the CWSRF Program, it is missing an opportunity to use the PERs as a tool to address national deficiencies and highlight best practices that are applicable across multiple states.

We analyzed the 22 PERs and found that 41 percent of the state reviews identified deficiencies in Davis-Bacon compliance documentation. The results of this analysis are summarized in table 6.

**Table 6: Potential state trends identified in 22 OIG-reviewed PERs**

Issue	Number of states in which issue was identified
Lack of Davis-Bacon documentation	9
Lack of documentation in general	4
Concerns with state staffing	4
Ineligible expenses (erroneous payments)	2
Buy American documentation or compliance concerns	3

Source: The 22 most recent PERs provided by EPA regions, written as of July 30, 2010.

Note: A state could have more than one issue identified.

EPA could analyze PERs to identify potential best practices in state oversight. Fourteen of the PERs we reviewed identified best practices. EPA staff recognized three states for maintaining thorough project files and two states for having thorough inspection checklists. EPA can use best practices identified in PERs to inform states of ways to improve their oversight of projects.

EPA could also analyze PERs to identify needed changes or improvements in Agency policies, procedures, and processes. The Agency can use this trend analysis information to make national decisions to improve the program. Doing so will help reduce the Agency's vulnerability to fraud, waste, abuse, and mismanagement.

In addition to state trends, EPA could use PERs to develop a more risk-based approach to oversight. Currently, the regions are supposed to conduct the same level of review twice a year for each state. However, EPA could use PER results to identify states and program areas that may be at a lower or higher risk for not complying with statutory and ARRA requirements. A risk-based approach to selecting states for more extensive review would lead to more efficient operations.

### ***EPA Not Using Available Oversight Resources***

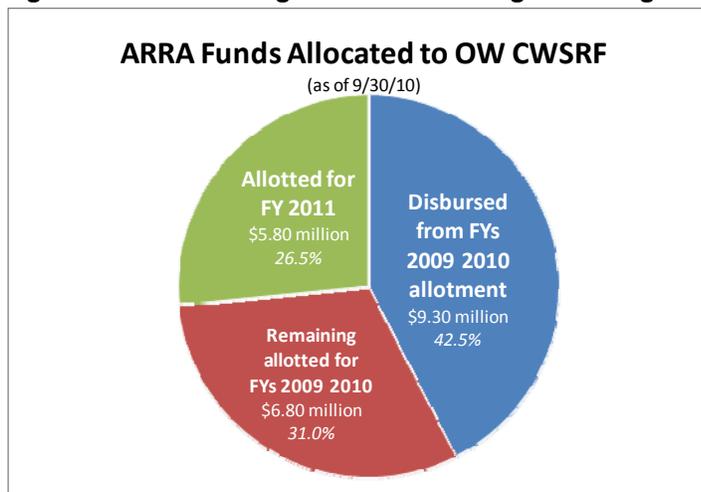
EPA regions have stated they do not have adequate resources to write PERs in a timely manner. For example, two EPA regions were dealing with staffing issues that resulted in PERs not being written. One of these regions mitigated the resource challenge by hiring or transferring staff from other offices. In addition, some EPA regions stated that the process of writing up the PERs is time-intensive.

We also found that EPA did not fully use the resources available from the ARRA funding. Specifically, ARRA provided the Agency with management and oversight funding, \$25 million of which was allocated to the OW CWSRF Program. However, in response to a congressional inquiry about unneeded funds, EPA determined that over \$3 million in unexpended management funds

previously allotted to the CWSRF Program could be reduced, and this amount was rescinded by Congress as part of a larger \$10 million rescission of ARRA funds.

Figure 1 shows that the OW CWSRF Program had \$6.8 million in management and oversight funds remaining at the end of fiscal years (FYs) 2009–2010, and was allotted an additional \$5.8 million for FY 2011. Therefore, OW will have \$12.6 million available for management and oversight of the CWSRF Program in FY 2011, more than it has spent since the inception of ARRA in February 2009.

**Figure 1: ARRA management and oversight funding**



Source: EPA OW data.

### ***EPA Not Identifying Delayed Completion of PERs as a Risk***

In the stewardship plan for ARRA, EPA identified the PERs as a control for addressing risks such as ARRA program goals not being met and funds not being used appropriately. While the PERs were not being written timely, EPA did not identify the issue as a risk in its 2010 Federal Managers' Financial Integrity Act (FMFIA) assessment and in its September 2010 quarterly stewardship plan report.

OMB's ARRA guidance states that agencies must take steps, beyond standard practice, to initiate additional oversight mechanisms to mitigate the unique implementation risks of ARRA. Agencies were to use appropriate internal control assessments to assess the risks and define strategies to prevent fraud, waste, and abuse. In addition, in response to OMB's ARRA guidance, EPA developed a stewardship plan. The stewardship plan is an Agency-level risk mitigation plan that sets out the Agency's ARRA risk assessment, internal controls, and monitoring activities. OW identified PERs as a control activity to address the risk that funds were not used appropriately and program goals were not met. The quarterly report on the status of the implementation of the stewardship plan for September 2010 did not identify any issues with OW's implementation of that

plan, even though our review found that regions were not timely completing or documenting the PERs.

EPA did not identify regional oversight of states as a risk to the CWSRF Program during its FY 2010 FMFIA process. The FMFIA assurance letter states, “[t]he internal controls within OW are adequate to reasonably ensure the protection of the program operations, functions, and resources.” The assurance letter states that OW is in compliance with EPA’s ARRA stewardship plan and that it is monitoring the risks and internal controls identified in the plan. However, as our review found, regions are neither timely completing and documenting the PERs nor fully realizing the benefits of PERs.

## Conclusion

OMB guidance states that the unique implementation risks of ARRA merit increased oversight by the Agency. Therefore, the Agency should strengthen its oversight process to ensure state program compliance and continuing improvement of the program. The process for regional semiannual ARRA reviews of state programs and the resulting PERs is a primary control that EPA established for overseeing state ARRA programs. However, EPA is not completing these reviews timely. EPA should increase its oversight of state CWSRF ARRA programs and adopt a risk-based approach to oversight. Specifically, OW should strengthen the review checklist, emphasize that this process is a priority by establishing a deadline for the reviews and PERs, and use the PERs as a tool to make national decisions to improve the program.

## Recommendations

We recommend that the Assistant Administrator for Water:

3. Update the semiannual ARRA review checklist to include:
  - a. Detailed questions about state oversight of project construction.
  - b. Expanded transaction testing when erroneous payments are identified.
  - c. A question as to whether the project files contain appropriate documentation that the assistance recipient complied with Davis-Bacon Act requirements.
4. Update the state inspection checklist to include a review of Davis- Bacon documentation and a recommendation to independently verify compliance on a sample basis.
5. Establish deadlines for conducting the regional semiannual ARRA reviews of state programs and documenting them in PERs.

6. Use the PERs as a tool to assess Agency trends to make program decisions.
7. Use the risks that are identified in the PERs to determine the level of oversight needed for each state.
8. In the next quarterly stewardship plan report, discuss OW actions to address the timely completion of PERs.
9. In FYs 2011 and 2012, continue to identify the progress in completing PERs and determine whether failure to complete them, and complete them in a timely manner, should be identified as an office-level weakness.

## **Agency Response and OIG Comment**

In responding to the draft report, OW agreed with parts of our recommendation to revise the semiannual review checklist as written in the draft report. At the exit conference, the OIG discussed the recommendation and agreed to revise it in the final report to clarify the changes that we were recommending to the semiannual review checklist (recommendation 3) and added a new recommendation related to the state ARRA inspection checklist (recommendation 4). In responding to the draft report, the Agency stated that it would be revising the semiannual review checklist and recommending expanding transaction testing when warranted. In responding to the final report, OW should provide a milestone date for completing its corrective actions to the semiannual review checklist and state ARRA inspection checklist.

OW agreed with recommendation 5, to establish deadlines for conducting the reviews of state programs and documenting the program evaluations. OW stated that it requires that the state reviews be conducted within 60 days of receiving the state's annual report, and that the program evaluation be documented within 60 days of the review. At the exit conference, OW managers stated that the direction was only provided orally during conference calls with regions. The PERs are a primary tool that EPA uses to oversee states. EPA should hold regions accountable for completing the PERs, but holding regions accountable is difficult without written requirements. In responding to the final report, OW should provide a milestone date as to when it plans to document the decision on when reviews are to be conducted and when PERs are to be completed.

OW agreed with recommendation 6, to use the PERs to make program decisions. EPA used the PERs, in addition to interaction with states and regions during reviews, summary finding memos, individual checklists for projects and transactions, and semiannual summaries to identify best practices and identify trends for needed changes and improvements in the program. EPA has used all of this information to develop program priorities, including expanding the annual

review checklists, conducting 3-day training in oversight procedures in each regional office between March and October 2011, establishing discussion points during the monthly coordinator calls, and updating standard operating procedures for regional staff. We analyzed the annual review checklist and the agenda for the 3-day training, and they do address the issues in the report. However the Agency was not able to provide information on the monthly coordinator calls, and the updated operating procedures only addressed the issue of expanding testing when erroneous payments were found.

We agree that these actions are beneficial; however, many of the actions EPA referred to in its comments took place after we conducted field work. For the activities described in the response, EPA relied upon personal knowledge of staff regarding the results of the reviews of state programs, and not on a documented review of the PERs. EPA should view PER analysis, as recommended in the report, as part of its internal control structure. According to OMB Circular A-123, risk assessment is one component of internal controls. When conducting risk assessment, management should consider internal management reviews, and the identified risks should be analyzed for their potential impact. EPA Manual 2750 on audit follow-up requires the action official, or delegated program manager, to maintain documentation on implementation of corrective actions. For this recommendation, the documentation should include how the PERs were used in developing program priorities, revising the checklist, and updating training and standard operating procedures. We are retaining our original recommendation because we believe the PERs contain valuable information on issues states are encountering in implementing the program. EPA should conduct and document a systematic review of the PERs each year to help management make informed decisions about the program.

In response to recommendation 7, on using the risks in the PERs to determine level of oversight needed of states, OW stated that it is already a core part of EPA oversight. However, we observed that EPA does not base its level of oversight on risk. EPA provides a standardized checklist that is followed for all states. A risk-based approach would modify the checklist based on results of previous PER reviews. For example, if a state did not have any problems with the accuracy of transactions for the past 3 years, a region may consider reducing oversight in that area. As the Chief Financial Officer stated in a March 2011 memorandum, the potential for a tight fiscal environment in the future means that the Agency should rethink how it does business.<sup>4</sup> In this area, OW should use a risk-based approach to oversight rather than one size fits all. In responding to the final report, OW should provide specifics on how regions use the results of previous PER reviews to adjust state program oversight.

OW concurred with recommendation 8, to include in the next quarterly stewardship plan report a discussion of OW actions to address the timely

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<sup>4</sup> Memorandum from Barbara J. Bennett, Chief Financial Officer, "Guidance on EPA's FY 2013 Annual Plan and Budget Summer Process," May 26, 2011.

completion of the PERs. In responding to the final report, OW should provide a milestone date for completing the corrective action.

In response to recommendation 9, on considering the untimely completion of PERs as an office-level weakness in FY 2011 or 2012, OW stated that it would monitor completion of PERs, but did not agree to identify untimely completion of PERs as an office-level weakness. OW's rationale for not identifying this as an office-level weakness was that ARRA oversight activities will largely be completed by the end of FY 2012. However, OW is scheduled to submit its FY 2011 annual assurance letter in August 2011. OW can analyze the progress of PERs completion and still consider whether it should be an office-level weakness for FY 2011.

In responding to the draft report, the Agency did not provide planned completion dates for the proposed recommendations. For this reason, the recommendations are unresolved. In responding to the final report, the Agency will need to provide a corrective action plan and milestone dates for completion.

## **Status of Recommendations and Potential Monetary Benefits**

RECOMMENDATIONS						POTENTIAL MONETARY BENEFITS (in \$000s)	
Rec. No.	Page No.	Subject	Status <sup>1</sup>	Action Official	Planned Completion Date	Claimed Amount	Agreed-To Amount
1	11	Develop and implement a plan to supplement the state inspections with EPA inspections of ARRA projects that includes expanded testing to verify compliance with ARRA requirements	U	Assistant Administrator for Water			
2	11	Require states to follow the updated state ARRA inspection checklist and reference guide when inspecting ARRA projects.	U	Assistant Administrator for Water			
3	18	Update the semiannual ARRA review checklist to include: <ul style="list-style-type: none"> <li>a. Detailed questions about state oversight of project construction.</li> <li>b. Expanding transaction testing when erroneous payments are identified.</li> <li>c. A question as to whether the project files contain appropriate documentation that the assistance recipient complied with Davis-Bacon Act requirements.</li> </ul>	U	Assistant Administrator for Water			
4	18	Update the state inspection checklist to include a review of Davis-Bacon documentation and a recommendation to independently verify compliance on a sample basis.	U	Assistant Administrator for Water			
5	18	Establish deadlines for conducting the regional semiannual ARRA reviews of state programs and documenting them in PERs.	U	Assistant Administrator for Water			
6	19	Use the PERs as a tool to assess Agency trends to make program decisions.	U	Assistant Administrator for Water			
7	19	Use the risks that are identified in the PERs to determine the level of oversight needed for each state.	U	Assistant Administrator for Water			
8	19	In the next quarterly stewardship plan report, discuss OW actions to address the timely completion of PERs.	U	Assistant Administrator for Water			
9	19	In FYs 2011 and 2012, continue to identify the progress in completing PERs and determine whether failure to complete them, and complete them in a timely manner, should be identified as an office-level weakness.	U	Assistant Administrator for Water			

<sup>1</sup> O = recommendation is open with agreed-to corrective actions pending  
C = recommendation is closed with all agreed-to actions completed  
U = recommendation is unresolved with resolution efforts in progress

## ***Details on Scope and Methodology***

We reviewed relevant criteria documents, including the CWA, CWSRF regulations, ARRA and associated OMB guidance, and relevant ARRA CWSRF websites. We analyzed OW guidance given to EPA regions and states for oversight, including recommended ARRA inspection checklists for states conducting site visits. Additionally, we reviewed the FMFIA risk assessment and the EPA Recovery Act Stewardship Plan for Reporting. We developed and conducted a risk assessment of all 50 states and Puerto Rico that took into consideration the following:

- Most recent PERs for each state as of March 2010
- FYs 2006–2008 single audit findings for each state
- Available FYs 2006–2008 financial statement independent audit findings
- Indicators of untimely use of funds:
  - FYs 2006–2008 unliquidated obligations
  - FYs 2006–2008 National Information Management System financial ratios
- State program size based on ARRA CWSRF allotments
- State project status
- Information from other product lines and divisions within the OIG

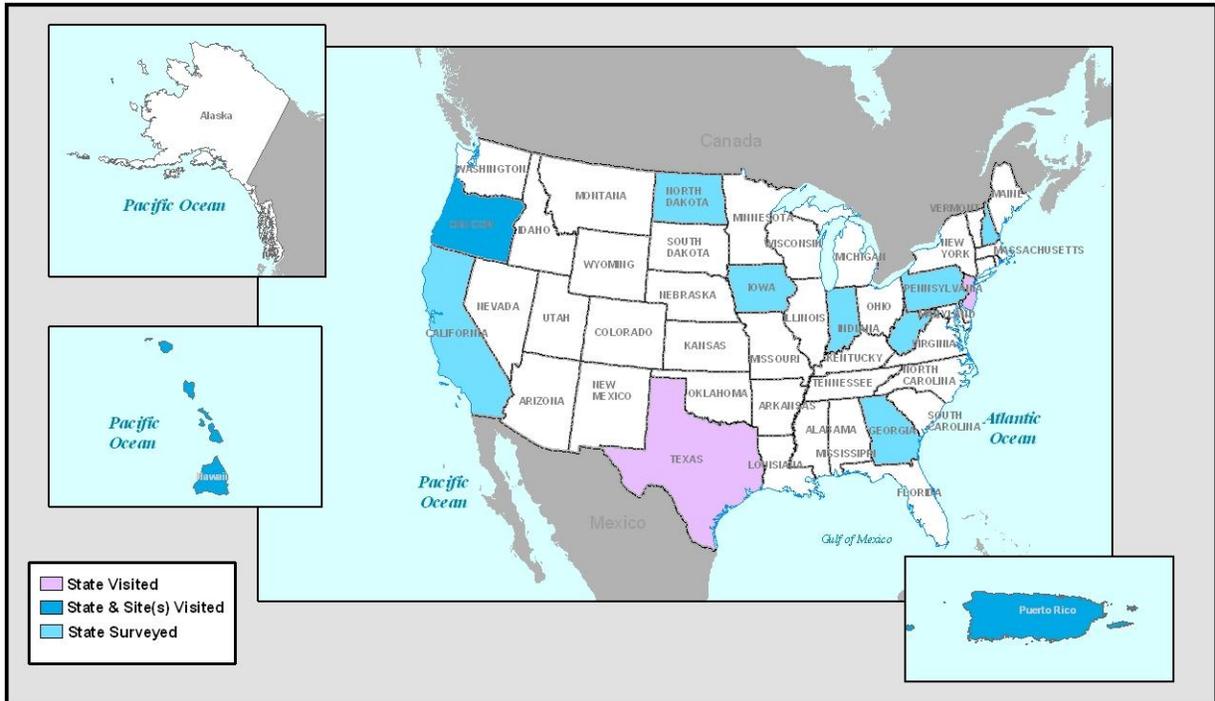
With the results of this risk assessment and consideration of prior audits, we selected five states/territories to visit: Texas, Oregon, New Jersey, Hawaii, and Puerto Rico. On these state visits, we reviewed EPA-state OAs, capitalization grant agreements, construction manuals, and other guidance. We analyzed the states' most recent ARRA PERs and conducted further analyses based on the reports we received. We also interviewed state CWSRF representatives about state oversight processes.

In conjunction with state visits, we conducted five construction site visits of CWSRF projects—two visits in Oregon and three visits in Puerto Rico. While visiting construction sites, we:

- Walked through the site with project staff
- Interviewed project staff
- Reviewed project file documentation (e.g., inspection files, loan/grant agreements, change orders, etc.)
- Reviewed bid tabulations and independent engineering cost estimates
- Reviewed ARRA documentation (i.e., Buy American certifications and payroll certifications), comparing the subrecipient-maintained ARRA documentation to EPA's guidance

To complement our state and site visits, we selected a judgmental sample of seven regions and nine states/territories to survey. We asked Regions 1, 3, 4, 5, 7, 8, and 9 about any limitations they faced in conducting their reviews, progress on their semiannual ARRA reviews, and frequency of site visits. We also surveyed California, Iowa, Indiana, Georgia, North Dakota, New Hampshire, Pennsylvania, Puerto Rico, and West Virginia regarding states' subrecipient monitoring processes. Figure A-1 portrays our audit coverage of states visited and surveyed.

**Figure A-1: States reviewed**



Source: EPA OIG.

We reviewed internal and management controls in the context of EPA and state subrecipient monitoring. We reviewed the Agency's ARRA stewardship plan and quarterly monitoring reports. In its stewardship plan, the Agency identified procedures it would follow to mitigate oversight risks associated with ARRA. The quarterly monitoring reports identify ARRA-funded program risks to Agency management. We reviewed documents OW prepared to comply with FMFIA. We reviewed assurance letters and risk assessments for FYs 2009 and 2010.

OMB ARRA guidance instructed EPA to prepare program plans to identify resources and use of funds. EPA's CWSRF Program finalized its plan on May 15, 2009. We reviewed this plan to identify use and timing of ARRA funding.

**Regional Performance Evaluations of States:  
Elapsed Time and Findings**  
(Reviews and Corresponding Reports Completed as of September 30, 2010)

EPA region	State	Date of review	Date of final PER	Elapsed months	Findings
1	ME	( <sup>a</sup> )	( <sup>a</sup> )		No findings
	RI	( <sup>a</sup> )	08/03/10		• Concerns with state staffing
	VT	07/13/10	( <sup>a</sup> )		No findings
2	PR	02/04/10	03/01/10	0.8	• Lack of documentation in general
3	DE	09/23/09	11/24/09	2.0	No findings
	MD	02/23/10	08/03/10	5.3	• State not maintaining Buy American certifications in project files
	PA	10/21/09	03/08/10	4.5	• Lack of documentation in general • Lack of Buy American and Davis-Bacon documentation
	VA	12/09/09	06/21/10	6.4	• Lack of Davis-Bacon documentation
	WV	11/19/09	06/15/10	6.8	No findings
4	FL	04/16/10	( <sup>a</sup> )		No findings
	GA	03/12/10	( <sup>a</sup> )		No findings
	KY	05/27/10	( <sup>a</sup> )		No findings
	NC	05/14/10	( <sup>a</sup> )		No findings
	TN	05/12/10	( <sup>a</sup> )		No findings
5	IL	10/29/09	01/21/10	2.8	• Lack of documentation in general • Lack of Davis-Bacon documentation • Concerns with state staffing • Concerns with state inspections of projects
	MI	10/22/09	01/21/10	3.0	• Lack of Davis-Bacon documentation • Concerns with state staffing • Ineligible expenses
	MN	11/19/09	1/21/10	2.1	• Lack of Davis-Bacon documentation
	OH	04/15/10	07/30/10	3.5	• Single audit compliance concerns
	WI	11/13/09	02/02/10	2.7	• Lack of Davis-Bacon documentation • Concerns with state staffing
	6	AR	04/14/10	07/20/10	3.2
LA		02/03/10	07/27/10	5.7	No findings
NM		05/21/10	08/25/10	3.2	• Lack of documentation for Disadvantaged Business Enterprise, documentation of ARRA and of accounting procedures
OK		06/22/10	08/16/10	1.8	No findings

EPA region	State	Date of review	Date of final PER	Elapsed months	Findings
7	IA	01/15/10	05/21/10	4.1	No findings
	KS	04/13/10	06/09/10	1.9	• Ineligible expenses
	MO	03/24/10	05/20/10	1.9	• Concern with state staffing
	NE	12/07/09	03/23/10	3.5	No findings
8	CO	04/14/10	07/13/10	3.0	No findings
	MT	05/13/10	06/16/10	1.1	• One Davis-Bacon Issue
	ND	03/01/10	06/01/10	3.0	No findings
	UT	07/29/10	10/06/10	<sup>b</sup> 2.3	• Lack of documentation on file
	WY	07/01/10	08/03/10	1.1	No findings
9	AZ	12/14/09	07/22/10	7.2	• Lack of documentation in general • Lack of Davis-Bacon documentation
	CA	01/14/10	05/01/10	3.5	• Lack of Davis-Bacon documentation
	HI	03/19/10	10/21/10	<sup>b</sup> 7.1	• Concerns with state staffing
10	AK	10/30/09	08/25/10	9.8	• Lack of documentation on file
Average elapsed months <sup>c</sup>				3.7	

Source: Most recent PERs received from EPA headquarters and regional CWSRF coordinators as of September 30, 2010.

Note: Only includes states for which PERs have been completed and provided to the OIG. A number of regions have either not conducted reviews or have conducted reviews but not written or finalized the associated PERs.

<sup>a</sup> PER did not provide date.

<sup>b</sup> Report issued after September 30, 2010.

<sup>c</sup> Average elapsed months only includes reports for which we had date of on-site review and date PER was issued.

## ***Agency's Response to Draft Report***

The response from Office of Water is provided verbatim. OIG responses to those comments have been inserted in text boxes

UNITED STATES ENVIRONMENTAL PROTECTION AGENCY  
WASHINGTON, D.C. 20460

MAY 11 2011

OFFICE OF  
WATER

### MEMORANDUM

**SUBJECT:** Response to Draft Report: EPA and States Should Strengthen Oversight of Clean Water State Revolving Fund Recovery Act Projects, Project No. OA FY10 0088

**FROM:** Nancy K. Stoner  
Acting Assistant Administrator

**TO:** Melissa M. Heist  
Assistant Inspector General for Audit

Thank you for the draft report transmitted on April 4, 2011, entitled, "EPA and States Should Strengthen Oversight of Clean Water State Revolving Fund Recovery Act Projects." I appreciate the effort involved in reviewing the inspection and oversight procedures of such a large and fast-paced program, and I welcome the opportunity to respond.

The report documents a number of findings regarding EPA and State oversight procedures as well as the frequency and effectiveness of project inspections. Additionally, the report contains eight recommendations regarding oversight of both States and projects. While I agree with the report's assertion that oversight of such a large and complex program is essential to prevent fraud, waste, and abuse, many of the conclusions reached in the report, are based on assumptions limited sample sizes, and in some instances, incomplete understanding of the Clean Water State Revolving Fund program.

While we disagree with many of the conclusions in the report, we concur with and are implementing most of the recommendations, which are generally reflective of good management practices. Attachment 1 provides the office of Water response to the recommendations included in the draft report. Appendix 2 identifies specific concerns regarding the facts and findings of the draft report.

Again, thank you for the opportunity to respond to these timely findings and recommendations. If you have and comments or questions regarding this response, please contact me or Sheila Frace, Director, Municipal Support Division, Office of Wastewater Management, at (202) 564-1153.

Attachments

## Attachment 1

### Responses to Recommendations

1. Identify which States do not sufficiently oversee CWSRF projects and require those States to develop written corrective action plans to ensure adequate oversight of subrecipients. The corrective action plans must address whether the frequency of site inspections is sufficient to mitigate the risk of noncompliance with ARRA requirements.

The Office of Water does not concur with the recommendation. Site inspection is only one of many approaches to reduce noncompliance, and only mitigates the risk in the very few instances of willful and knowing noncompliance. Although site inspection can be an effective way to identify unknowing noncompliance, they do not reduce the risk of such noncompliance as cost effectively as through education and compliance assistance.

Comprehensive inspections (independent of frequency) can discover instances of noncompliance after they have occurred. Prudent management requires us to consider the nature, effect, and available options for resolving noncompliance when evaluating the needed frequency of inspections. Further, given finite and constrained resources, increased frequency of inspections may adversely impact the quality and comprehensiveness of inspections undertaken.

Through reviews of State programs and onsite inspections, following the regional oversight management plan, the Office of Water has been able to determine which States need to do a better job of inspecting projects under ARRA. Regional staff are required to accompany State staff on at least one, and preferably two, project inspections each year under ARRA, affording EPA the opportunity to gauge the States' oversight and inspection process. The Office of Water has provided training for State programmatic staff and local staff, and has provided contractor support to assist with project inspections for States with limited resources.

EPA will be independently inspecting up to 30% of all CWSRF ARRA projects during the remainder of the calendar year 2011.

2. Require States to test and verify that subrecipient documentation complies with ARRA requirements.

The Office of Water does not concur with this recommendation. Beyond the question of whether EPA possesses the legal authority to impose the recommended requirement, virtually all States are already inspecting projects and many are using or incorporating specific elements from the inspection checklist developed by the program. Regional staff are required to accompany State staff on at least one, and preferably two, project inspections each year under ARRA. The Office of Water has provided training for State programmatic staff and local staff, and has provided contractor support to assist with project inspections for States with limited resources. The Office of Water will be independently inspecting up to 30% of all CWSRF ARRA projects during the remainder of the calendar year 2011.

3. Update the semiannual ARRA review checklist to include:
  - a. Detailed questions about State oversight of project construction.
  - b. Detailed questions about Davis-Bacon and Buy American documentation review and a

- recommendation to independently verifying (sic) compliance on a sample basis.
- c. A recommendation for expanded transaction testing when erroneous payments are identified.

The Office of Water concurs with recommendation 3(a) and the first element of recommendation 3 (b). The existing checklist already includes these types of questions, but the questions will be supplemented during a checklist revision. The Office of Water does not concur with the second element of recommendation 3(b), which appears to be completely misplaced, as it does not pertain to the review checklist, but appears to be related to recommendation 2 above. While recommendation 3(c) is likewise misplaced and does not pertain to the review checklist, the Office of Water agrees to the recommendation to expand transaction testing, but only where warranted by cases of serious, or systemic erroneous payments. Regarding recommendation 3(c), based on findings to date, our transaction tests are sufficiently rigorous when combined with our state reviews to identify if additional transaction tests should be incorporated into a future review as a follow-up item.

4. Establish deadlines for conducting the regional semiannual ARRA reviews of State programs and documenting them in PERs.

The Office of Water concurs, as this recommendation has already been implemented. Semiannual ARRA reviews are to be done approximately every 6 months, and are typically coordinated with the established schedule of the primary annual review. The primary annual review is a pre-existing and ongoing monitoring element of the base CWSRF program. It is recommended that the primary annual review be conducted within 60 days of receipt of the State's annual report, which is to be submitted within 90 days of the end of the State's fiscal year. As a result, the schedule does not comport with the Federal Fiscal Year. Guidance has already been issued directing PERs to be issued within 60 days of a review.

5. Use the PERs as a tool to assess Agency trends to make program decisions.

The Office of Water concurs, as this is already a core part of EPA oversight. EPA used the PERs, in addition to interaction with States and Regions during reviews, summary finding memos, individual checklists for projects and transactions, and semiannual summaries to identify best practices and identify trends for needed changes and improvements in the program. EPA has used all of this information to develop program priorities, including: expanding the annual review checklists; conducting 3-day training in oversight procedures in each Regional office between March and October 2011; establishing discussion points during the monthly coordinator calls; and updating Standard Operating Procedures for Regional staff.

6. Use the risks that are identified in the PERs to determine the level of oversight needed for each State.

The Office of Water concurs, as this is already a core part of EPA oversight. It must be noted, however, that EPA provides findings to States during the exit conference of the State review and initiates corrective actions, if needed, well before final PERs are signed. This approach allows EPA the flexibility, for example, to increase the number of project file reviews even during the course of the ongoing review or in supplementary reviews should an issue be identified. It also allows State to immediately begin corrective actions, as needed.

7. In the next quarterly stewardship plan report, discuss OW actions to address the timely completion of PERs.

The Office of Water concurs.

8. In FYs 2011 and 2012, continue to identify the progress in completing PERs and determine whether failure to complete them, and complete them in a timely manner, should be identified as an office-level weakness.

The Office of Water concurs with recommendation to continue monitoring the progress in completing PERs. The Office of Water does not concur with the recommendation to make a determination of weakness based on results from FY2011 and FY2012, given that CWSRF ARRA oversight activities will have been largely, if not fully completed by end of FY2012.

## Attachment 2

### Comments on Findings

#### Chapter 2: States Should Strengthen Oversight of CWSRF Projects

##### **Page 8: States Not Ensuring Compliance with Certain ARRA Provisions**

The report states that four of five States visited do not independently verify compliance with ARRA requirements. This conclusion does not appear to be supported by any of the facts presented in this section. Independent verification of Buy American and Davis-Bacon documentation is not required, as noted in the report, by EPA guidance. State programs review project files to determine if proper documentation has been received. However, no State has the resources to determine independently the accuracy of the claims made by contractors and suppliers. States were instructed to include provisions in loan agreements requiring verification by assistance recipients and by requiring assistance recipients to include language in contracts signed with contractors, suppliers and vendors that would hold responsible any party making false claims. Requiring each party to independently verify documentation would have created an inefficient application of the ARRA requirements leading to construction delays that would have violated the spirit of the ARRA.

In developing the inspection checklist, EPA made a conscious decision to focus the State's reviews on verifying that the assistance recipient was performing due diligence and appropriate oversight of ARRA projects. The inspection checklist was not intended to be an instrument for the States to fully duplicate the ARRA oversight activities which were the responsibility of the assistance recipient. This decision was made based on the following:

- Assistance recipients bear the ultimate responsibility for ensuring compliance with ARRA requirements, as they are the parties contracting for construction and purchasing materials;
- States do not have the staff or resources to complete duplicative oversight of the numerous ARRA-funded projects;
- EPA does not have the authority to require States to perform detailed inspections of ARRA projects; and
- The Davis-Bacon grant condition developed by the Office of Grants and Debarment did not require States to perform independent assessments.

The report states that for Davis-Bacon Act wage requirements, the EPA checklist only requires States to confirm that the subrecipient was verifying compliance. However, when the instructions for the checklist are followed, there is a thorough process for confirming compliance that extends beyond merely reviewing signed compliance statements. The process is as follows:

- Review payroll records to ensure they are present for every week;
- Ensure employees are paid weekly;
- Check for signed statement of compliance;
- Confirm that the assistance recipient conducted employee wage interviews, which ask whether the employee is being paid the appropriate wage rates;
- Check that the Davis-Bacon wage rates and the WH-1321 poster are posted conspicuously and in relevant languages;
- Confirm that the wage rates posted are those used in the construction contract;
- Have assistance recipients describe the methodology used to review payroll records;
- Verify that fringe benefits have been reviewed;
- Confirm that the assistance recipient has reviewed all appropriate documentation and

- eligibility for all apprentices and trainees working onsite.
- Verify that the ratio of trainees to journeymen complies with the approved plan;

**OIG Response:** The steps identified above are included in the revised checklist that EPA provided when responding to the draft report. However, Regions did not conduct these steps during the 2010 state performance evaluations that we reviewed during the audit because the Regions did not use a site inspection checklist during the semiannual ARRA reviews. Implementation of the revised checklist steps will address the findings in the report.

Again, the checklist is designed to confirm Davis-Bacon compliance, not to repeat actions already conducted by the assistance recipient. The assistance recipient is also required to submit certifications on a regular basis to certify that it has complied with the Davis-Bacon requirements, as laid out in the grant agreement.

The report states that 48 of 53 Buy American certifications for the five projects reviewed did not include sufficient documentation to verify compliance. Only one example is given, where a supplier stated that material made in Canada automatically complies. Without further details related to these finding, it is impossible to comment. The report also states that in 26 of 53 instances, the country of origin of components used to manufacture the goods were not identified. However, if the good is manufactured in the US, there is no need to identify the country of origin of the components. OMB guidance has clearly established that there is no requirement with regard to the origin of components or subcomponents in manufactured goods, as long as the manufacture of the goods occurs in the United States.

**OIG Response:** We included additional examples in the report and provided additional documentation where regions requested the information.

The report cites one example where Davis-Bacon documentation was reviewed and found that a recipient did not ensure contractors complied with wage requirements. There are no supporting details regarding this finding. Due to the complexities of the Davis-Bacon requirements, it is impossible to determine whether the IG inspectors were correctly applying the Davis-Bacon requirements.

**OIG Response:** We removed the example from the final report.

The report states that loan agreements between States and recipients include a requirement that the State ensure compliance with all ARRA requirements but does not mention that the States can simply delegate this requirement to the loan recipients. However, the IG is misinterpreting the requirements of the loan agreements and the execution of these agreements. The recipients are required to perform due diligence to ensure compliance with ARRA requirements. The States are required to verify that such due diligence has occurred, thereby ensuring compliance. This is accomplished through the use of inspection checklists, which with outline specific steps to be taken by State inspectors.

## Page 9: State Inspection Frequency of ARRA CWSRF Projects Varied

Noting the varied frequency of project inspections, the report states, "According to EPA management, when Congress created the CWSRF program, it intended for states to have flexibility in implementing their programs." This conclusion is supported by the brevity of the implementing language, the legislative history, and the continued funding by Congress of a program that has not been changed or reauthorized since 1987. Congress has never granted the authority for EPA to require additional oversight of projects by State programs or to mandate a particular number or frequency of inspections. The report notes that the IG has concluded that EPA has such authority, however, no support or accompanying legal analysis for this conclusion is given.

The report states that when a State conducts more frequent inspection, more issues of noncompliance are found. This is a faulty conclusion. It specifically highlights 5 States. Two States do quarterly inspections, one does monthly inspections, one does biweekly inspections, and another does inspections when the project is 30%, 50% and 90% complete. First, the report concludes that the State that inspects at certain milestones (30%, 50%, and 90%) inspects a project fewer times than one that inspects quarterly. Construction projects with duration of less than 9 months would actually be inspected more frequently in such a State. The report then shows that in this State, no violations were found, concluding that less frequent inspections leads to no findings of violations. In this case, a faulty assumption leads to a faulty conclusion. Even if the assumption that fewer inspections were performed was correct, the conclusion would be based on a very small sample size, which is wholly insufficient to draw a conclusion or even establish a correlation. Furthermore, the frequency of the inspections is not necessarily related to the number of violations found. The occurrence and discovery of violations would be based on a variety of factors, including but not limited to subrecipient understanding of requirements, willingness to ensure compliance, and technical and managerial competency to achieve compliance.

## Page 10: States Not Using Administrative Set-Aside

The report states that, "Six of the 13 States that we surveyed were not using any of their administrative set-aside funds" and that, "One state indicates that resource limitations did not allow it to review ARRA applications in a timely manner. However, this State did not use its administrative set-aside." It isn't clear why this observation is relevant, as all States met the statutory deadline of "under contract or construction" and thus were, by definition, timely.

**OIG Response:** While all projects were under construction, one state did tell the auditors that not all applications were reviewed and that those not reviewed were instead considered for the next SRF funding opportunity.

More importantly, it is critical to recognize that States have their own rules in place that can make utilizing a sharp and sudden increase in funds difficult. State-wide hiring freezes and furloughs and legislative spending caps created a lengthy process in some States and an impossible situation in others. Despite the fact that States were able to access an increased amount of funds under the 4% set-aside, many were unable to do so in a timely or useful manner, and unable to hire staff to deal with the increased workload. State programs and EPA had very little control over this process. Finally, some

States chose to use 100% of funds provided to build projects, which clearly aligns with the goals of ARRA.

### **Chapter 3: EPA Should Strengthen Oversight of States**

#### **Page 13: EPA Required to Oversee State Programs**

The report states EPA implemented various actions in response to GAO recommendations, for example, increasing frequency of regional reviews and sampling of project files and transaction testing. This is incorrect. EPA had actually adopted these changes in the Stewardship Plan developed the previous year.

#### **Page 14: EPA's Review Checklist Did Not Ensure State Program Compliance**

The report states that the semiannual ARRA review checklist did not include enough detailed questions to ensure State compliance. Specifically that the checklist was lacking detailed questions about State oversight of project construction, Davis-Bacon and Buy American documentation review and a recommendation to spot-check to verify compliance, and a recommendation for expanded transaction testing when erroneous payments are identified.

Expanded transaction testing when erroneous payments are identified may not be practical in the time frame of any given review considering the time involved per transaction, however, it may be feasible as a follow-up item for future visits.

The finding that the checklist is not detailed enough regarding oversight of program requirements does not take into consideration that Regions, in addition to performing semiannual State reviews, are required to examine all files and documents within a project file relating to such requirements and are required to accompany State staff on at least 1 project review per State. The examination of all project file documents and the experience of accompanying State staff on reviews provide Regional staff with the ability to accurately assess State program compliance. Checklists are used as a guide for program reviews and have been released in conjunction with detailed training sessions for Regional staff.

#### **Page 14: EPA Not Timely Conducting and Writing Reviews of State Programs**

The report states that EPA OW management did not establish a timeframe for completion of PERs, however, EPA instituted a 60 day requirement for submission of PERs in FY 2011. The report also states that both EPA OW management and Regional management did not establish as a priority the writing and documenting of reviews in a timely manner. EPA communicated regularly with all EPA Regional staff regarding the frequency and timing of the semiannual reviews of ARRA programs. EPA also provided contractor support to each Region for the reviews and every Region accepted this offer. EPA HQ staff attended and participated in reviews in most States during 2009 and 2010 to oversee the review process. Regions are aware of the findings of reviews prior to the exit conference of the review. EPA also receives the findings of any review activities completed by their contractor in memo form within 2 weeks of completion of the review. We agree that timeliness of completion of the review memo is important and will strive to ensure that all Regions meet the established deadline. It should be noted, however, that EPA communicates all findings to States at the State review exit conferences and corrective actions begin long before final PERs are signed.

## Page 15: EPA Not Using PERs to Make Agency Program Decisions

The report states that EPA did not use the PERs to collectively make Agency decisions to improve the program or to analyze national trends. EPA used the PERs, in addition to interaction with States and Regions during attendance of reviews, summary finding memos, individual checklists for projects and transactions, and semiannual summaries to identify best practices and identify trends for needed changes and improvements in the program. As noted above, PERs are used to document findings that have already been presented to State programs and acted upon by EPA. EPA has used all of this information to develop program priorities, including:

- Expanding the annual review checklists;
- Conducting 3-day training in oversight procedures in each Regional office between March and October 2011;
- Establishing discussion points during the monthly coordinator calls;
- Editing Standard Operating Procedures for Regional staff in conducting reviews;
- Determining the need for additional specific training on topics such as Buy American and Davis-Bacon compliance.

Again, conclusions are presented without any supporting examples or documentation.

**OIG Response:** Our review considered PERs completed during FY 2010. These activities took place after that time. At the time of the review, OW had neither accumulated nor analyzed the PER reviews to identify areas in which improvements in guidance or oversight were needed.

### Additional Factual Corrections

Table 5 shows Regions having only completed 49 reviews as of September 30, 2010. This number is incorrect, and likely indicates at minimum, confusion regarding the data requested. Footnote (a) in Table 5 indicates Region 3 completed two reviews for each of its' 5 states, while the Table inconsistently reports 5 reviews and 5 reports. The footnote also incorrectly indicates EPA guidance specifies a review cycle based on the fiscal year. Further, Region 5 completed all 6 PERs.

Appendix B only lists one review for each State, which is incorrect. Further, it is missing all reviews for Indiana.

**OIG Response:** The information in appendix B summarizes the PER reports that were completed as of September 30, 2010, and provided to the OIG. Chapter 3, table 5, lists the number of actual reviews that were completed. While a region may have completed a review, if it did not also complete the report, we were not able to analyze what the review found. Therefore, the review is not included in appendix B. Regarding Indiana, we confirmed that the PER report was not completed as of September 30, 2010. Therefore, we have not revised the report.

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