



OFFICE OF INSPECTOR GENERAL

Catalyst for Improving the Environment

Audit Report

Utah Department of Environmental Quality Water Quality State Revolving Fund Fiscal Year 2004 Financial Statements

Report No. 2005-1-00144

August 8, 2005

Abbreviations

CFR	Code of Federal Regulations
DEQ	Utah Department of Environmental Quality
EPA	United States Environmental Protection Agency
GAAP	Generally Accepted Accounting Principles
SRF	State Revolving Fund



At a Glance

Catalyst for Improving the Environment

Why We Did This Review

We performed this audit to determine:

- If Utah Water Quality State Revolving Fund's financial statements were fairly presented in all material respects;
- To what extent that Utah Water Quality State Revolving Fund's internal controls over financial reporting could be relied upon; and,
- Whether the Utah Water Quality State Revolving Fund complied with applicable laws and regulations.

Background

The requirement for audited financial statements was enacted to help ensure that State Revolving Fund programs had management practices, systems and controls in place to provide reliable information for managing the federally funded program.

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

To view the full report, click on the following link:

www.epa.gov/oig/reports/2005/20050808-2005-1-00144.pdf

Utah Department of Environmental Quality Water Quality State Revolving Fund Fiscal Year 2004 Financial Statements

What We Found

We rendered an unqualified opinion on the financial statements of Utah's Water Quality State Revolving Fund (SRF) for the fiscal year ended June 30, 2004.

We qualified our opinion on compliance with applicable laws and regulations because:

- The SRF entered into loans with 30-year repayment terms. The Clean Water Act requires loans to be repaid within 20 years.
- Utah violated Section 603(d) of the Clean Water Act by depositing hardship assessments of \$3,334,560 into the SRF and transferring hardship assessments of \$3,128,088 to the Hardship Fund.
- The Department of Environmental Quality (DEQ) disbursed \$479,961 from the SRF that was considered ineligible.
- The SRF needs to fully meet the Single Audit responsibilities for pass-through entities and ensure that loan recipients met the Single Audit requirements and findings are adequately addressed.

We noted weaknesses in internal controls. DEQ internal controls failed to prevent the SRF disbursement, recording and reporting of \$479,961 in ineligible assistance.

What We Recommend

We recommend that EPA:

- Require the DEQ to take the necessary steps to ensure proper review and approval of transactions, including the proper use of accounting codes, to further ensure SRF funds are used only when intended and for authorized purposes.
- Require Utah to modify the three loans with extended financing terms to comply with the Clean Water Act.
- Prohibit Utah from making loans with terms extending beyond 20 years.
- Cease allowing States to violate the Clean Water Act based on an Office of Water draft policy.
- Require Utah to transfer the remaining \$206,472 in hardship assessments in the SRF as well as any subsequent receipts, to the Hardship fund.
- Require Utah to make appropriate adjustments to accounts and procedures to deposit and account for the hardship assessment fees outside the SRF.
- Require Utah to implement a Single Audit Review and corrective action policy consistent with Federal Regulations.
- Require the DEQ to take steps to ensure that established review and approval procedures are understood and followed so that assistance is provided, recorded and reported by the appropriate program. Add procedures to ensure that all assistance recorded in the SRF are supported by documentation.



UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C.

OFFICE OF
INSPECTOR GENERAL

August 8, 2005

Memorandum

Subject: Auditor's Report for the Utah Department of Environmental Equality
Water Quality State Revolving Fund Program as of June 30, 2004
Audit Report No. 2005-1-00144

From: William M. Dayton
National SRF Audit Manager

To: Robbie Roberts
Regional Administrator
EPA, Region 8
Denver, CO

Attached is a copy of the subject audit we sent to the State of Utah. The audit contains reports on the financial statements, internal controls, and compliance requirements applicable to the Clean Water State Revolving Fund (SRF) program in Utah for the year ended June 30, 2004.

We have issued an unqualified opinion on the financial statements and a qualified opinion on the compliance requirements, as discussed in our report on compliance. In our report on internal controls, we noted an issue involving the internal control structure and its operations that we considered to be a material weaknesses.

In accordance with EPA directive 2750, the Action Official is required to take action on the findings and recommendations in this report within 150 days.

The OIG has no objection to the release of this report to any member of the public upon request. The report contains no confidential business or proprietary information.

If you have any questions or concerns regarding this matter, please feel free to contact me at (916) 498-6590 or Mr. Paul Felz at (303) 312-6270.

Attachment

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UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C.

OFFICE OF
INSPECTOR GENERAL

Independent Auditor's Report

We have audited the accompanying statement of net assets of the Utah Department of Environmental Quality's (DEQ) State Revolving Fund (SRF) program as of June 30, 2004, and related statements of revenues, expenses, and changes in net assets, and cash flows for the year then ended. These financial statements are the responsibility of the SRF's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the SRF as of June 30, 2004, and the results of its operation and its cash flows for the year then ended in conformity with generally accepted accounting principles in the United States of America.

As discussed in Note 1, the financial statements referred to above are intended to present the financial position and results of operations and cash flows of Utah's DEQ Water Quality SRF program. They do not purport to, and do not, present fairly the financial position as of June 30, 2004 or the results of operations and cash flows for the year then ended for the State of Utah or the Utah DEQ in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated February 4, 2005, on our consideration of the SRF's internal control structure and a report dated February 4, 2005, on the SRF's compliance with laws and regulations.

Office of Inspector General
February 4, 2005

**Utah Department of Environmental Quality
State Revolving Fund
Statement of Net Assets
June 30, 2004**

	<u>Loan Fund</u>	<u>Hardship Fund</u>	<u>Total</u>
Assets:			
Cash and cash equivalents	\$ 39,443,248	\$ 6,163,383	\$ 45,606,631
Current receivables:			
Loan interest	214,112		214,112
Hardship fees		740,440	740,440
Project administrative fees	93,450		93,450
Due from other funds	479,961	206,472	686,433
Due from EPA	7,698		7,698
Penalties	8,965		8,965
Current portion of loans receivable	<u>7,783,595</u>		<u>7,783,595</u>
Total current receivables	8,587,781	<u>946,912</u>	9,534,693
Loans receivable - long term	<u>107,959,492</u>		<u>107,959,492</u>
Total assets	<u>\$ 155,990,521</u>	<u>\$ 7,110,295</u>	<u>\$ 163,100,816</u>
Liabilities and Net Assets:			
Current liabilities:			
Due to other funds	<u>307,619</u>		<u>307,619</u>
Total current liabilities	307,619		307,619
Total liabilities	<u>307,619</u>		<u>307,619</u>
Net Assets:			
Restricted net assets	<u>155,682,902</u>	<u>7,110,295</u>	<u>162,793,197</u>
Total net assets	<u>155,682,902</u>	<u>7,110,295</u>	<u>162,793,197</u>
Total liabilities and net assets	<u>\$ 155,990,521</u>	<u>\$ 7,110,295</u>	<u>\$ 163,100,816</u>

See accompanying notes to the financial statements.

**Utah Department of Environmental Quality
State Revolving Fund
Statement of Revenues, Expenses and Changes in Net Assets
For the Fiscal Year Ended June 30, 2004**

	<u>Loan Fund</u>	<u>Hardship Fund</u>	<u>Total</u>
Revenues:			
Loan interest	\$ 629,561		\$ 629,561
Project administration fees	67,730		67,730
Hardship assessments		\$ 1,599,546	1,599,546
Other fees	4,161		4,161
EPA grant administration	<u>122,691</u>		<u>122,691</u>
Total revenues	824,143	1,599,546	2,423,689
Expenses:			
Personal Services	156,393		156,393
Travel	2,478		2,478
Data Processing	1,120		1,120
Other	<u>30,430</u>		<u>30,430</u>
Total expenses	<u>190,421</u>		<u>190,421</u>
Operating income	633,722	1,599,546	2,233,268
Investment interest	580,441	75,621	656,062
Capital contributions	<u>2,099,363</u>		<u>2,099,363</u>
Change in net assets	3,313,526	1,675,167	4,988,693
Total net assets, beginning of year	<u>152,369,376</u>	<u>5,435,128</u>	<u>157,804,504</u>
Total net assets, end of year	<u><u>\$ 155,682,902</u></u>	<u><u>\$ 7,110,295</u></u>	<u><u>\$ 162,793,197</u></u>

See accompanying notes to the financial statements.

**Utah Department of Environmental Quality
State Revolving Fund
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2004**

	Loan Fund	Hardship Fund	Total
Cash flows from operating activities:			
Loan interest	\$ 697,671		\$ 697,671
Project administration fees	57,495		57,495
Hardship assessments received	1,549,814		1,549,814
Hardship assessments transferred to (from)	(1,443,632)	1,443,632	0
Other fees	4,505		4,505
EPA grant-administration	118,100		118,100
Operating expenses	(175,595)		(175,595)
Disbursements to Twin Creeks	(479,961)		(479,961)
Loan disbursements	(11,438,938)		(11,438,938)
Loan principal repayments	12,501,846		12,501,846
Net cash provided by (used by) operating activities	1,391,305	1,443,632	2,834,937
Cash flows from capital and related financing activities:			
Funds received from EPA	1,492,816		1,492,816
Funds received from State of Utah	606,547		606,547
Net cash provided by capital and related financing activities	2,099,363		2,099,363
Cash flows from investing activities:			
Investment interest	580,441	75,621	656,062
Net cash provided by investing activities	580,441	75,621	656,062
Increase in cash and cash equivalents	4,071,109	1,519,253	5,590,362
Cash and cash equivalents beginning of year	35,372,139	4,644,130	40,016,269
Cash and cash equivalents, end of year	39,443,248	6,163,383	45,606,631

See accompanying notes to the financial statements.

**Utah Department of Environmental Quality
State Revolving Fund
Statement of Cash Flows
For the Fiscal Year Ended June 30, 2004**

	<u>Loan Fund</u>	<u>Hardship Fund</u>	<u>Total</u>
Reconciliation of operating income to net cash provided by operating activities:			
Operating income	\$ 633,722	\$ 1,599,546	\$ 2,233,268
Adjustments to reconcile operating income to net cash provided by operating activities:			
(Increase) decrease in interest/fee receivable	68,110	(49,732)	18,378
(Increase) decrease in project administration fee receivable	(10,235)		(10,235)
Decrease in penalty receivable	344		344
(Increase) in receivable from EPA	(4,591)		(4,591)
Increase in due to other fund	121,008		121,008
(Increase) in due from other fund	(479,961)	(106,182)	(586,143)
Loan disbursements	(11,438,938)		(11,438,938)
Loan principal repayments	<u>12,501,846</u>	<u> </u>	<u>12,501,846</u>
Net cash provided by operating activities	<u>\$ 1,391,305</u>	<u>1,443,632</u>	<u>\$ 2,834,937</u>

See accompanying notes to the financial statements.

**Utah Department of Environmental Quality
Water Quality State Revolving Fund
Notes to Financial Statements**

Note 1. Organization of The Fund

The Water Quality SRF program was established pursuant to Federal action to provide assistance to public water systems for projects that meet eligibility requirements. The SRF program allows the State to provide low interest rate loans to finance qualified publicly owned preservation and protection projects. The United States Environmental Protection Agency (EPA) allows up to 4% of the Capitalization Grants for administration of the program. This funding allows for supervision of the program by qualified technical staff that provides project management oversight.

The Utah Water Quality Board (the Board), an eleven-member board appointed by the Governor, develops policies and procedures for program implementation and authorizes loans under the SRF program. The Department of Environmental Quality and the Board jointly manage the program, while the DEQ reviews loan applications for eligibility, prioritizes eligible projects, monitors loan repayments, and conducts project inspections. Through Utah Code, the legislature empowers the Board with rule-making authority that meets Federal law requirements. The Board reviews each loan applicant to determine its ability to repay the loan, its readiness to proceed with the project, and its ability to complete the project.

The SRF receives assistance and support from the Department of Environment Quality's Office of Support Services, the State Division of Finance, the State Attorney General's Office, and the State Treasurer's Office. The salaries and benefits of the employees, as well as indirect costs based on direct salary costs, are charged to the Fund based on time spent on SRF activities. Employees charging time to the SRF are covered by the State of Utah personnel benefits plan. The Division of Finance charges loan administration fees to the program.

The SRF is capitalized by a series of grant awards from EPA. States are required by the Clean Water Act to provide an additional 20 percent the Federal capitalization grant in matching funds. The SRF activities are included in the Utah Comprehensive Annual Financial Report as part of the Proprietary Funds (Water Loan Programs). The Fund's assets, liabilities, and net assets are not separately identified in Utah's financial statements, which uses economic resources measurement focus and accrual basis of accounting.

Note 2. Summary of Significant Accounting Policies

The accounting policies of the SRF conform in all material respects with generally accepted accounting principles (GAAP) as prescribed by the Governmental Accounting Standards Board.

Basis of Accounting

The SRF program financial statements are presented as an enterprise fund. As such, the financial statements are prepared using the economic resources measurements focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when the related

**Utah Department of Environmental Quality
Water Quality State Revolving Fund
Notes to Financial Statements**

Note 2. Summary of Significant Accounting Policies (continued)

liability is incurred, regardless of the timing of the cash flows. All assets and liabilities associated with the operation of the funds are included in the balance sheet. The State has elected to follow the accounting pronouncements of the Governmental Accounting Standards Board (GASB), as well as statements issued by the Financial Accounting Standards Board (FASB) on or before November 30, 1989, unless the pronouncements conflict with or contradict GASB pronouncements.

Cash and Cash Equivalents and Investments

The State Treasurer, in accordance with the Money Management Act, Section 51-7 of the Utah Code, administers cash and investment management in the State. The Act specifies the investments that may be made. The investments include variable rate corporate notes and obligations of U.S. Government agencies that base their rates on standard quoted money market indexes that have a direct correlation to the federal funds rate. Cash equivalents are generally considered short-term highly liquid investments with maturity of three months or less from the purchase date.

All funds deposited with the treasurer are considered to be cash or cash equivalents regardless of the actual maturities of the underlying investments in the statement of cash flows. Shares are valued at fair value in accordance with Governmental Accounting Standards Board Statement No. 31, "Accounting and Financial Reporting for Certain investments and for External Investment Pools," which requires all investments in debt and equity securities to be reported at fair value in the balance sheet and all investment income, including changes in the fair value of investment, to be reported in the statement of revenue and expenses.

Loans Receivable

Loans are funded by (1) Federal capitalization grants, (2) State matching funds, (3) loan repayments, and (4) fund earnings. A project is funded through the purchase of an incremental disbursement bond. The proceeds are drawn as needed and deposited in the escrow account. Monies are disbursed to borrowers on a cost reimbursement basis. Interest begins accruing when funds are deposited in the escrow account. Repayment must begin no later than one year after completion of the project. The interest rates on the loans vary but are lower than market rates and, in some cases, are non-interest bearing. No provision for uncollectible accounts has been made as all loans are current, and management believes that all loans will be repaid according to the loan terms.

Hardship Assessments

The Board has the option to charge a hardship assessment in lieu of interest on certain loans. Hardship assessments are calculated and paid in the same manner as interest. The program restriction for the use of hardship assessments differs from the restriction for the use of interest. Hardship assessments are collected with loan repayments in the SRF and then transferred to and

**Utah Department of Environmental Quality
Water Quality State Revolving Fund
Notes to Financial Statements**

Note 2. Summary of Significant Accounting Policies (continued)

accounted for in the Hardship Fund. These funds can be used for purposes other than loans, including grants to disadvantaged communities for project planning.

Contributed Capital

In accordance with generally accepted accounting principles, funds received from the EPA and the State of Utah for the capitalization of the Fund are reported as non-operating revenues. Funds received from EPA to reimburse administrative costs are reported as operating revenues.

Note 3. Cash and Cash Equivalents

All monies of the SRF are deposited with the Utah State Treasurer and are considered cash. The Treasurer is responsible for maintaining the cash balances in accordance with the Utah Money Management Act. Utah's Money Management Act requires the Treasurer to invest these funds in a manner that: (1) ensures maximum safety of principal; (2) provides adequate liquidity to meet all operating requirements; and (3) achieves the highest possible return on investment consistent with the primary objectives of security and safety. Details of the funds invested in the Utah Public Treasurer's Investment Fund can be obtained from the State Treasurer.

The SRF program, including the loan fund and the hardship fund, earned \$656,062 from investments in the Utah Public Treasurer's Investment Fund during fiscal year 2004. Investments in local government investment pools are not categorized because they are not evidenced by securities that exist in physical or book entry form. The fair value of cash and investments are presented below:

	Loan Fund	Hardship Fund	Total
	<u> </u>	<u> </u>	<u> </u>
Cash	\$ 60,386	\$ 52,030	\$ 112,416
Investments	<u>39,382,862</u>	<u>6,111,353</u>	<u>45,494,215</u>
Total	<u>\$ 39,443,248</u>	<u>\$ 6,163,383</u>	<u>\$ 45,606,631</u>

**Utah Department of Environmental Quality
Water Quality State Revolving Fund
Notes to Financial Statements**

Note 4. Loans Receivable

Loans are made from the SRF to qualified entities for projects that meet the eligibility requirements. Capitalization grants, State match, interest earnings, and principal repayments to the revolving fund are sources that finance the loans. Effective interest rates and hardship fees on loans vary between 0.0 and 5.0 percent and are generally repaid over 20 years starting 1 year after the project has been complete. Loans mature at various intervals and recipients make annual payments. DEQ has extended the repayment term up to 30 years for certain projects based on EPA's draft extended financing policy.

Loan activity during fiscal year 2004 is summarized as follows:

<u>Loan Status</u>	<u>Loan Amount Authorized</u>	<u>Loan Balance June 30, 2003</u>	<u>Disbursements</u>	<u>Repayments</u>	<u>Loan Balance June 30, 2004</u>
In disbursement	\$ 27,330,000	\$ 1,400,000	\$ 5,800,100	\$ -	\$ 7,200,100
Completed	<u>157,631,396</u>	<u>115,405,996</u>	<u>5,638,838</u>	<u>12,501,847</u>	<u>108,542,987</u>
Total	<u>\$184,961,396</u>	<u>\$116,805,996</u>	<u>\$11,438,938</u>	<u>\$12,501,847</u>	<u>\$115,743,087</u>

Loans mature at various intervals through June 30, 2024 and the scheduled principal repayments on completed projects in subsequent years follow:

<u>Fiscal Year(s)</u>	<u>Projected Principal</u>	<u>Projected Interest</u>	<u>Projected Hardship</u>	<u>Projected Total Payments</u>
2005	\$ 7,694,395	\$ 777,150	\$1,343,427	\$ 9,814,972
2006	7,869,061	729,909	1,248,065	9,847,035
2007	8,054,993	681,075	1,149,449	9,885,517
2008	8,127,413	630,517	1,047,310	9,805,240
2009	8,189,701	578,208	946,435	9,714,344
2010 - 2014	35,835,252	2,083,846	3,225,240	41,144,338
2015 - 2019	21,620,463	968,239	999,234	23,587,937
2020 - 2024	7,982,709	187,945	63,126	8,233,779
2025 - 2029	<u>3,169,000</u>	<u>-</u>	<u>-</u>	<u>3,169,000</u>
Total	\$108,542,987	<u>\$6,636,889</u>	<u>\$10,022,287</u>	<u>\$ 125,202,162</u>
Loans in disbursement	<u>7,200,100</u>			
Total at June 30, 2004	<u>\$115,743,087</u>			

**Utah Department of Environmental Quality
Water Quality State Revolving Fund
Notes to Financial Statements**

Note 5. Due From Other Funds

As of June 30, 2004, \$479,961 had been erroneously drawn from the SRF for disbursement to Twin Creeks, a separate State loan program loan. The entry was corrected subsequent to year end.

Note 6. Due To Other Funds

The amount of "Due to Other Funds" is an aggregation of amounts due to DEQ to reimburse DEQ for costs associated with administering the SRF and the amount due to the Hardship Fund for hardship assessments collected and deposited in the loan fund. As of June 30, 2004, \$101,148 was due to DEQ to reimburse for administration costs and \$206,472 was due to the Hardship Fund for Hardship assessments received.

Note 7. Capitalization of the Fund

The EPA capitalization grants and the state match capitalize the Loan Fund. Loan program draws and state match are recorded as non-operating revenues.

Through June 30, 2004, the SRF received grant awards totaling \$122,804,294. EPA funds of \$117,496,710 had been drawn for first round projects and SRF administration. Another \$7,698 was due from EPA. The State had contributed \$23,761,581 in matching funds to the loan fund. As of June 30, 2004, \$5,307,584 of funds allocated to the SRF loan program has not been drawn.

Note 8. Contingencies and Subsequent Events

The SRF is exposed to various risks of loss related to torts, thefts of assets, errors or omissions, injuries to state employees while performing SRF business, or acts of God. The SRF is included in Utah's Risk Management Fund, which provides insurance in case of loss or claims against the Fund.

On July 8, 2004, the 2004 Capitalization Grant was awarded. Grant funds were still available from the 2003-year award, which postponed the need for 2004 monies. The 2004 award has not been included in these financial statements.

On November 26, 2004, funds in the amount of \$487,000, for the Twin Creeks SSD loan, were transferred in from state funds to replenish amounts previously disbursed from the State Revolving Fund.

**Utah Department of Environmental Quality
Water Quality State Revolving Fund
Notes to Financial Statements**

Note 8. Contingencies and Subsequent Events (continued)

As of June 30, 2004, the Board had approved funding authorizations for four communities totaling \$16,145,000 for loans that had not closed:

	Authorized <u>Loan Amount</u>
Moroni City	\$ 2,635,000
Stockton Town	1,870,000
North Fork SSD	1,640,000
Hooper City	<u>10,000,000</u>
Total Outstanding Commitments	<u>\$ 16,145,000</u>

**Independent Auditor's Report on the
Internal Control Structure Based on an
Audit of the Financial Statements
Performed in Accordance with
*Government Auditing Standards***



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

OFFICE OF
INSPECTOR GENERAL

We have audited the financial statements of the Utah Department of Environmental Quality's (DEQ) Water Quality State Revolving Fund (SRF) program as of and for the year ended June 30, 2004, and have issued our report thereon dated February 4, 2005.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of the SRF is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgements by management are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the financial statements of the SRF for the year ended June 30, 2004, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and; not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

However, we noted a matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the SRF's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The reportable condition is described in the accompanying section of Internal Control Finding and Recommendation.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the specific internal control elements does not reduce to a relatively low level the risk that errors and irregularities – in amounts that would be material in relation to the financial statements being audited – may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above.

This report is intended for the managers of the SRF and the EPA. However, this report is a matter of public record and distribution is not limited.

Office of Inspector General
February 4, 2005

Internal Control Finding and Recommendation

Failure in Operation of Controls Over Recording of Loans

SRF assistance must meet the eligibility requirements of Title VI of the Clean Water Act and 40 CFR, Part 35. During fiscal year 2004, the SRF was erroneously used to purchase four warrants totaling \$479,961 from the Twin Creeks Special Service District. SRF management intended to use a state loan program to purchase these warrants because the project did not meet the eligibility requirements of the SRF. However, undetected accounting errors resulted in SRF funds being used instead of state funds. The accounting errors, which were not detected during management review and approval of the individual transactions, resulted in the SRF disbursing, recording and reporting \$479,961 in ineligible assistance. The error appears to have been a result of a new SRF manager's lack of familiarity with the accounting funds and codes used to record transactions. The errors were corrected subsequent to year's end.

Recommendation: We recommend that EPA require the DEQ to take the necessary steps to ensure proper review and approval of transactions, including the proper use of accounting codes, to further ensure SRF funds are used only when intended and for authorized purposes.

Utah's Response

Utah agreed with our finding and recommendation, and added:

We concur with the finding and recommendation. The SRF was used to purchase warrants from Twin Creeks Special Service District, however, management had intended to use a separate state loan fund to purchase these warrants and review and approve transactions before recording....Our standard operating procedure is to request all draws from the SRF using a memorandum that identifies the appropriate funding source. This memo is initialed by two individuals and provides a double check on each withdrawal. This memo was not used for any of the Twin Creeks SSD draws due to the draws being for interim financing. In the future, this standard operating procedure will be adhered to regardless of the type of financing being provided and no funds will be drawn from the SRF without the use of this memorandum, which identifies accounting codes used in the memorandum.

Independent Auditor's Report
on Compliance with Requirements Applicable to the
Utah State Revolving Fund Program
in Accordance with
Government Auditing Standards



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

OFFICE OF
INSPECTOR GENERAL

We have audited the financial statements of the Utah Department of Environmental Quality's Water Quality State Revolving Fund (SRF) program as of and for the year ended June 30, 2004, and have issued our report thereon dated February 4, 2005.

We have also audited the SRF's compliance with specific program requirements governing allowability for specific activities, allowable types of assistance, State matching funds, period of availability of funds and binding commitments, cash management, program income, and subrecipient monitoring that are applicable to the SRF for the year ended June 30, 2004. The management of the SRF is responsible for compliance with those requirements. Our responsibility is to express an opinion on those requirements based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards, *Government Auditing Standards* issued by the Comptroller General of the United States, and the *Environmental Protection Agency Office of Inspector General's State Revolving Fund Audit Guide*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the above requirements occurred. An audit includes examining, on a test basis, evidence about the Fund's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, except for matters discussed in the findings and recommendations section that follows, the SRF complied, in all material respects, with the specific program requirements that are applicable to the Fund for the year ended June 30, 2004.

This report is intended for the information of management of the SRF and the EPA. However, this report is a matter of public record and its distribution is not limited.

Office of Inspector General
February 4, 2005

Compliance Findings and Recommendations

Loan Terms Do Not Comply With Clean Water Act

Utah entered into three loans that exceed the 20-year repayment terms established by the Clean Water Act. Utah awarded these loans based on EPA's draft Extended Financing policy which states:

...section 603(d)(2) [the buying or refinancing provision] does not carry with the limitations applicable to loans under 603(d)(1), namely that such loans are made at or below market rate, including interest free loans, at terms not to exceed 20 years.

The Utah SRF finances eligible projects by purchasing bonds issued by the community. EPA and Utah have taken the position that purchasing the community's bonds is exempt from the 20-year loan provisions.

We do not agree that purchasing a community's bonds under section 603(d)(2) is exempt from the loan terms and restrictions of section 603(d)(1). According to the House and Senate Conference Report (House 99-1004), the purpose of the buying or refinancing provision was to:

...encourage municipalities to proceed with construction with their own means of interim financing in advance of availability of a loan from the revolving fund, by offering municipalities the prospect of project financing at reasonably better financial terms at a later date.

Similarly, the Senate Debate on Conference Report, dated January 14, 1987, states:

In the case of municipalities which proceed to begin construction with their own funds, refinancing is permitted from a State revolving loan fund. Presently, most municipalities wait until it is their turn to receive Federal construction grant funding before they begin constructing needed facilities. This refinancing feature of the Revolving Loan Program would eliminate the disincentive for municipalities to move ahead quickly with construction that now exists with the grants program.

In our opinion, Congress intended the buying or refinancing provision as a means to accelerate construction, not to circumvent the loan terms of 603(d)(1). Further, congressional records do not make any distinction between loans or bonds as a means of financing local projects. By making loans with extended financing terms, amounts that could be used to finance other needed projects were delayed.

We recommend that EPA:

1. Require Utah to modify the three loans with extended financing terms to comply with the Clean Water Act.
2. Prohibit Utah from making loans with terms extending beyond 20 years.

3. Cease allowing States to violate the Clean Water Act based on an Office of Water draft policy.

Utah's Response

Utah did not agree with our finding and recommendations, and stated:

"We disagree with the finding. We obtained approval from EPA prior to issuing loans in excess of 20 years. EPA clearly approved of DWQ making loans with terms exceeding 20 years as evidenced by Utah receiving its capitalization grants in FY 2002, FY 2003 and FY 2004 based upon yearly SRF Intended Use Plans that explicitly indicated that some of the funds were earmarked for 25 or 30-year loans. In addition, DWQ had prior correspondence with EPA that indicated that loans could be made with repayment terms in excess of 20 years, as stated in the following email dated July 18, 2002...:

...SRF loans can be extended beyond 20 years, 30 years or the useful life of the facility, whichever is less, provided that assistance is to economically disadvantaged communities (as determined by the state) and the long term revolving level of your SRF is less than 10% over 30 years due to these extended financial assistance agreements. Your 2003 IUP ... shows that the four loans...have or will receive extended financing and these will decrease your program's revolving level by 0.42%. From a practical standpoint, the two situations you have described will not cause the 10% threshold to be exceeded.

Corrective Action Planned: Extended Financing came about through a draft memorandum issued [by EPA]....However, as this memorandum was never finalized, we will continue making federal loans that exceed a repayment term of 20 years until EPA resolves this issue."

OIG's Comments:

There is nothing in the Clean Water Act that allows the SRF to provide loans with repayment terms exceeding 20 years. Nor is there anything in the Clean Water Act that says EPA has the authority to allow extended repayment terms, regardless of economic need of the community. We do not believe Congress would require loans be repaid within 20 years, but then allow longer terms on refinancing loans. We do agree that EPA should resolve this issue by obtaining an Office of General Counsel opinion.

Hardship Assessments Pass Through SRF

During 2003 and 2004, Utah deposited \$3,334,560 of hardship assessments into the SRF and subsequently transferred \$3,128,088 of hardship assessment fees out of the SRF. These actions violated the Clean Water Act by: (1) depositing non-SRF funds into the fund, and (2) then transferring the non-SRF funds (hardship assessments) to the Hardship Fund, which is not one of the authorized uses of SRF assets.

Title VI of the Clean Water Act specifies funds to be deposited and held in the SRF. Those

funds include the capitalization grant payments, state match, principal and interest on all loans, net proceeds of bond issues secured by the SRF, and SRF investment earnings. The Operating Agreement between EPA and Utah defines how Utah would establish and operate its SRF program. The Operating Agreement was amended on March 28, 1994 to state:

The recipient has established a Hardship Grant Fund outside of the SRF which will be used to provide grants to communities for projects that would not be economically feasible unless grant assistance is provided. Recipients of SRF loans will be charged a hardship grant assessment, as determined by the Water Quality Board, to be placed directly into the Hardship Grant Fund.

The SRF can be established within a multiple-purpose State financing program, however, the SRF must be a separate account or series of accounts dedicated solely to providing loans and other forms of financial assistance, but not grants. Utah's loan accounting system only allows interest and fees on loans to be recorded in the fund where the loan is recorded, in this case, the SRF. To overcome this limitation, Utah established a code to identify hardship loans, created a separate account to record the hardship assessments, and maintained a subsidiary ledger to ensure that amounts received were transferred to the hardship fund. While the hardship assessments were identified, not all funds collected had been transferred by year's end.

Utah is in violation of the Clean Water Act because it deposits hardship assessments in the SRF, and then uses the funds for unauthorized purposes. To the extent the funds were transferred out of the SRF, Utah, in effect, corrected its violation of the Operating Agreement. However, as of June 30, 2004, assessments amounting to \$206,472 had not yet been transferred out.

We recommend that EPA require Utah to:

1. Transfer the remaining \$206,472 in hardship assessments in the SRF at June 30, 2004, and any subsequent receipts of hardship assessments deposited into the SRF, to the Hardship Fund.
2. Make appropriate adjustments to accounts and procedures to deposit and account for the hardship assessment fees outside the SRF in accordance with the Clean Water Act and the current Operating Agreement.

Utah's Response

Utah agreed with our finding and recommendation, and stated:

"We have transferred all appropriate hardship assessments out of the SRF account that were recorded at June 30, 2004.... We have created a new account to record the hardship assessments separate from other SRF activity. We have also reviewed our year-end procedures to ensure that all appropriate year-end adjustments are made."

Monitoring of Borrowers' Single Audits Reports

The Department of Environmental Quality did not have procedures in place to ensure that borrowers met the requirements of the Single Audit Act in accordance with 40 CFR 35.3135(i). States monitor borrowers compliance with the Single Audit Act by obtaining and reviewing borrowers' Single Audit reports. The reports are then used to: (1) determine whether the loan recipients have spent Federal assistance funds in accordance with applicable laws and regulations, (2) ensure that appropriate corrective action is taken, and (3) determine whether adjustments to state loan records are necessary.

SRF staff were under the impression that the State Auditor's Office was performing that function. As a result, SRF management did not have any assurance that the communities complied with generally accepted accounting principles, or that SRF funds were audited.

Recommendation: We recommend that EPA require Utah to implement a Single Audit review and corrective action policy consistent with Federal regulations.

Utah's Response

Utah agreed with our finding and recommendation, and added:

"We have been active in monitoring the payments, compliance, and activities of subrecipients....We have also reminded subrecipients of their responsibility to obtain a Single Audit if required and submit a copy to the department for review."

Inappropriate Recording of Assistance in SRF

Any assistance provided by the SRF must meet the eligibility requirements of Title VI of the Clean Water Act and 40 CFR, Part 35. During fiscal year 2004, the SRF was erroneously used to purchase four warrants totaling \$479,961 from Twin Creeks Special Service District. SRF management had intended to use a separate State loan program to purchase these warrants since the project did not meet the eligibility requirements of the SRF. Upon purchase of the warrants, however, funds from the SRF were used instead of state funds. Although each of these transactions were reviewed and approved before recording, an error in the fund code went undetected, resulting in the SRF disbursing, recording and reporting \$479,961 in ineligible assistance. This error appeared to be the result, in part, of inexperienced personnel, due to recent turnover in program management and staff. This error was corrected subsequent to year's end.

Recommendation: We recommend EPA require the Department of Environmental Quality take appropriate steps to ensure that established review and approval procedures are understood and followed so that assistance is provided, recorded and reported by the appropriate program. Additional procedures should be added to ensure that all loans and other assistance recorded in the SRF are properly supported by SRF assistance documentation.

Utah's Response

Utah agreed with our finding and recommendation. See response to Independent Auditor's Report on the Internal Control Structure Based on an Audit of the Financial Statements Performed in Accordance with Government Auditing Standards.

Report Distribution

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State of Utah

Division of Water Quality, Utah Department of Environmental Quality