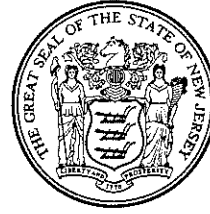

**New Jersey State Legislature
Office of Legislative Services
Office of the State Auditor**



**Department of Environmental Protection
Water Funds**

July 1, 2009 to February 18, 2011

**Stephen M. Eells
State Auditor**

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Governor of New Jersey

The Honorable Stephen M. Sweeney
President of the Senate

The Honorable Sheila Y. Oliver
Speaker of the General Assembly

Mr. Albert Porroni
Executive Director
Office of Legislative Services

Enclosed is our report on the audit of the Department of Environmental Protection, Water Funds for the period of July 1, 2009 to February 18, 2011. If you would like a personal briefing, please call me at (609) 292-3700.

A handwritten signature in black ink, appearing to read "Stephen M. Eells".

Stephen M. Eells
State Auditor
May 25, 2011

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Scope

We have completed an audit of the Department of Environmental Protection, Water Funds for the period July 1, 2009 to February 18, 2011. The audit included financial activities accounted for in the 14 special revenue funds identified in Appendix I. We also reviewed the financial activities for the federal American Recovery and Reinvestment Act (ARRA) funds related to the Clean Water and the Drinking Water State Revolving Funds. These ARRA grants totaled \$203.3 million.

The primary objective of the special revenues funds within our scope is to provide loans, grants, and administrative support to ensure the state's water resources and wastewater processes meet public health requirements. Total expenditures for the water funds, including ARRA money, for fiscal year 2010 were \$299 million. The major components of the expenditures were loans and state aid payments to municipalities. Revenues for fiscal year 2010 totaled \$287 million and were primarily derived from federal grants and bond proceeds.

Objectives

The objectives of our audit were to determine whether the financial transactions were related to the water funds, were reasonable, and were recorded properly in the accounting systems. We also determined whether the contract awarding process was in accordance with governing regulations and oversight was adequate. Special consideration was given to transactions involving ARRA funds. Our objectives were to determine whether the costs charged to ARRA projects were allowable; the funds were separately accounted for in the state's accounting system; and as with other federal funds, there were adequate controls to ensure effective cash management and timely reporting. We also tested for resolution of significant conditions noted in our prior report dated December 20, 2005.

This audit was conducted pursuant to the State Auditor's responsibilities as set forth in Article VII, Section I, Paragraph 6 of the State Constitution and Title 52 of the New Jersey Statutes.

Methodology

Our audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States.

In preparation for our testing, we studied legislation, the administrative code, circular letters promulgated by the Department of the Treasury, and policies and procedures of the department. Provisions that we considered significant were documented and compliance with those requirements was verified by interview, observation, and through our testing of financial transactions. We read the budget messages, reviewed financial trends, and interviewed department personnel to obtain an understanding of the programs and internal controls. We also reviewed the two ARRA grant agreements applicable to the water programs.

A nonstatistical sampling approach was used. Our samples of financial transactions were designed to provide conclusions about the validity of transactions, as well as internal control and compliance attributes. Transactions were judgmentally selected for testing.

To ascertain the status of findings included in our prior report, we identified corrective action taken by the department and walked through or performed tests to determine if the corrective action was effective.

Conclusions

We found that the financial transactions included in our testing were related to the water funds, were reasonable, and were recorded properly in the accounting systems. We found the contract awarding process to be proper and oversight of the contracts to be adequate except for timeliness of the ARRA inspections. We determined that costs charged to ARRA projects were allowable; the funds were separately accounted for in the state's accounting system; and there were adequate controls to ensure effective cash management and timely reporting. We also found that the department has resolved the significant issues noted in our prior report.

ARRA Project Inspections

ARRA inspections should be performed timely to verify compliance with loan agreements.

The Department of Environmental Protection (DEP) has received \$203.3 million in grant awards from the United States Environmental Protection Agency (EPA) under the American Recovery and Reinvestment Act of 2009 (ARRA) for the capitalization of the Drinking Water State Revolving Fund and the Clean Water State Revolving Fund programs. More than \$160 million of the ARRA funds have been spent as of January 2011. These ARRA funds were used to provide grants and loans to subrecipients, which are typically municipal or other local government entities, for approved construction and renovation projects. The grant agreements between DEP and EPA require the state to monitor the performance of their subrecipients to ensure that they comply with all applicable regulations, statutes, terms, and conditions. There are 69 loan agreements between DEP and subrecipients utilizing these ARRA funds.

For our review of the project oversight function performed by DEP, we examined project file documentation, including reports of on-site inspections. Two ARRA requirements that were included in our review were Davis-Bacon Act and Buy American. ARRA Section 1606 for Davis-Bacon prevailing wage requires that contractors and subcontractors pay wages and bona fide fringe benefits to their employees on a weekly basis at rates not less than the rates issued by the U.S. Secretary of Labor specific to the project's locality. Grant agreements required subrecipients to collect weekly payroll records along with a certification of compliance to Davis-Bacon from contractors or subcontractors. This documentation is to be made available at the request of DEP. The subrecipients were also required to review and provide written confirmation to DEP whether the project is in compliance with the prevailing wage requirements. ARRA Section 1605 Buy American requires that all iron, steel, and manufactured goods used for the project be produced in the United States.

Our initial sample of 11 ARRA projects disclosed that the procedures related to the application, permitting, awarding of the contract, and payment process were proper. However, when we reviewed the inspection process, we found 5 of these 11 ARRA projects had not been inspected for compliance with ARRA. We expanded our review to all 69 ARRA projects and found that as of December 31, 2010, 31 had not been subjected to an ARRA inspection even though many were more than 50 percent complete. Of the 38 projects inspected by DEP, we found the following.

- Twenty-nine subrecipients had not submitted the compliance certification indicating they had verified payroll records for Davis-Bacon prevailing wage or contractor fringe benefit contributions.
- Twenty-three subrecipients had not submitted the compliance certification indicating their contractor was in compliance with the Buy American requirements.

Although DEP may have performed interim inspections on these projects, their ARRA inspections are designed to review for compliance with the Davis-Bacon Act and Buy American requirements. DEP has one "ARRA inspector" to perform this function. Without adequate

oversight, DEP cannot ensure that the subrecipients have fulfilled their ARRA compliance responsibilities.

Recommendation

We recommend the department implement the necessary procedures to ensure that there is adequate monitoring of the subrecipients for compliance with the terms of the ARRA funded loan agreements.

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**Department of Environmental Protection
Special Revenue Water Funds
Total Expenditures Fiscal Year 2010****Appendix I**

Water Conservation Fund	\$3,189
Clean Waters Fund	\$1,000,586
Pinelands Infrastructure Trust Fund	\$2,092
Wastewater Treatment Fund	\$151,508,335
Natural Resources Fund	\$573,854
Water Supply Fund	\$23,476,887
Storm Management & Combined Sewer Overflow Abatement Fund	\$460,075
1992 Wastewater Treatment Fund	\$4,336,387
Water Resources and Wastewater Treatment Fund, 2003	\$55,328
Water Resources and Wastewater Treatment Trust Fund	\$0
Drinking Water State Revolving Fund	\$52,594,598
Clean Water State Revolving Fund	\$64,592,782
Safe Drinking Water Fund	\$0
Water Supply Replacement Trust Fund	\$0
Total	<u>\$298,604,113</u>



State of New Jersey

Department of Environmental Protection

PO Box 402
Trenton, NJ 08625-0402

CHRIS CHRISTIE
Governor

KIM GUADAGNO
Lt. Governor

BOB MARTIN
Commissioner

May 24, 2011

Mr. Stephen M. Eells
State Auditor
Office of the State Auditor
Office of Legislative Services
125 South Warren Street
PO Box 067
Trenton, New Jersey 08625-0067

Dear Mr. Eells:

Thank you for the opportunity to review and respond to the draft audit report regarding the Department of Environmental Protection, Water Funds, for the period July 1, 2009 to February 18, 2011.

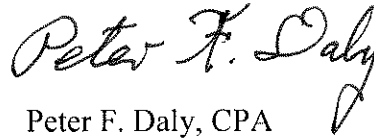
We are pleased that the audit concluded that the financial transactions included in your testing were related to the Water Funds, were judged to be reasonable and were accurately and properly recorded in the State's accounting systems.

It is also gratifying to note that the audit found our contract awarding process to be proper and the oversight of the contracts is adequate. We would like, however, to address, herein, the issue of the timeliness of our ARRA projects inspections.

While the Department recognizes and acknowledges that ARRA Compliance inspections may have not been performed within a time frame that kept up with the progress of construction, the Department's inspection schedule did fall within the EPA guidelines to conduct these inspections. In a recent review of our program, EPA also acknowledged that the accelerated pace of the ARRA program has caused problems nationwide with inspection schedules. In response, EPA has hired a contractor to assist states in accomplishing these inspections. New Jersey will have 20 inspections completed by Cadmus Engineering. We are currently working with EPA on a schedule to complete the inspections.

In closing, I would like to commend both the field audit staff for their professionalism and thoroughness exhibited during the course of the audit, as well as, the management and technical review staff for excellent oversight and guidance during this engagement.

Sincerely,

A handwritten signature in black ink that reads "Peter F. Daly". The signature is written in a cursive style with a large, stylized initial "P".

Peter F. Daly, CPA
Controller

C: Bob Martin, Commissioner
Magdalena Padilla, Esq., Chief of Staff