



OFFICE OF INSPECTOR GENERAL

Catalyst for Improving the Environment

Audit Report

State of New Hampshire Drinking Water State Revolving Fund Program Financial Statements for the Year Ended June 30, 2005

Report No. 2007-1-00044

February 26, 2007

Abbreviations

CAFR	Comprehensive Annual Financial Report
CFR	Code of Federal Regulations
DWSRF	Drinking Water State Revolving Fund
EPA	U.S. Environmental Protection Agency
GASB	Government Accounting Standards Board
NHDES	New Hampshire Department of Environmental Services
OIG	Office of Inspector General
OMB	Office of Management and Budget
SDWA	Federal Safe Drinking Water Act



At a Glance

Catalyst for Improving the Environment

Why We Did This Audit

We performed this audit to determine:

- Whether the New Hampshire Drinking Water State Revolving Fund Program's (the Program's) financial statements were fairly presented in all material respects,
- To what extent the Program's internal controls over financial reporting could be relied upon, and
- Whether the Program complied with applicable laws and regulations.

Background

The requirement for audited financial statements was enacted to help ensure that the Program 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/2007/20070226-2007-1-00044.pdf

State of New Hampshire Drinking Water State Revolving Fund Program Financial Statements for the Year Ended June 30, 2005

What We Found

We rendered an unqualified opinion on the New Hampshire Drinking Water State Revolving Fund (DWSRF) Program financial statements for the year ended June 30, 2005.

We noted various reportable conditions that we considered material weaknesses in internal controls. These deficiencies in the design and operations of internal controls for the DWSRF-specific financial accounting and reporting, in our judgment, could adversely affect the State's ability to record, process, and report financial data consistent with the assertions of management in the DWSRF financial statements. The State did not make adjustments for the identified discrepancies to cash and investment balances in the DWSRF general ledger, and did not compare the general ledger to original source documentation, resulting in numerous unrecorded transactions and errors going undetected. The State made incorrect journal entries, miscalculated match funding, incorrectly executed amortization schedules, did not record loan payments, and materially misstated cash balances and short-term investments.

We qualified our opinion on compliance with applicable laws and regulations because the required State match was underfunded by \$228,436, set-aside costs were not separated and identifiable by the actual costs, and the State did not follow up on subrecipient Single Audits.

What We Recommend

To correct the internal controls weaknesses, we recommend that EPA require the New Hampshire Department of Environmental Services to: coordinate with the State Treasury to obtain up-to-date documentation on cash and investment transactions, properly reconcile subsidiary schedules, develop and implement procedures for reviewing and reporting accounting transactions, and develop training on the accounting system. For the compliance issues, we recommend that EPA require the State to: deposit \$228,436 to correct the underfunded State matching funds, establish subcodes for each set-aside, and implement a policy for Single Audit report review.



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

OFFICE OF
INSPECTOR GENERAL

February 26, 2007

MEMORANDUM

SUBJECT: Auditor's Report for the State of New Hampshire
Drinking Water State Revolving Fund Program
Financial Statements for the Year Ended June 30, 2005
Report No. 2007-1-00044

TO: Robert W. Varney
Regional Administrator, EPA Region 1

Attached is a copy of the subject audit we sent to the State of New Hampshire. The audit contains reports on the financial statements, internal controls, and compliance requirements applicable to the Drinking Water State Revolving Fund program in New Hampshire for the year ended June 30, 2005. We 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 issues involving the internal control structure and its operations that we considered to be a material weaknesses.

This report represents the opinion of the Office of Inspector General and does not represent the final position of the U.S. Environmental Protection Agency (EPA). Final determination on matters in this report will be made by EPA managers in accordance with established audit resolution procedures.

The estimated cost of this report – calculated by multiplying the project's staff days by the applicable daily full cost billing rates in effect at the time – is \$134,635.

Action Required

In accordance with EPA Manual 2750, you are required to provide a written response to this report within 120 days. You should include a corrective actions plan for agreed upon actions, including milestone dates. Please email an electronic version of your response to kasper.janet@epa.gov.

We have no further objections to the further release of this report to the public. The report contains no confidential business or proprietary information. This report will be available at <http://www.epa.gov/oig>.

If you have any questions or concerns regarding this report, please contact Janet Kasper, the Director for Assistance Agreement Audits, at (312) 886-3059 or kasper.janet@epa.gov.

A handwritten signature in black ink, appearing to read "Bill A. Roderick", is written above a solid horizontal line.

Bill A. Roderick
Acting Inspector General

Attachment

State of New Hampshire Drinking Water State Revolving Fund Program
Financial Statements for the Year Ended June 30, 2005

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

OFFICE OF
INSPECTOR GENERAL

Independent Auditor's Report

We have audited the accompanying financial statements of the State of New Hampshire Drinking Water State Revolving Fund Program (the Program) as of and for the year ended June 30, 2005. These financial statements are the responsibility of the Program'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 the standards applicable to financial audits contained in *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.

As discussed in Note 1, the financial statements referred to above are intended to present the financial position, and the changes in financial position and cash flows, where applicable, of the Program. They do not purport to, and do not, present fairly the financial position of the State of New Hampshire as of June 30, 2005, and the changes in its financial position and its cash flows, where applicable, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements for the Program referred to above present fairly, in all material respects, the financial position of the Program, as of June 30, 2005, and the changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Office of Inspector General
May 24, 2006

**State of New Hampshire
Drinking Water State Revolving Fund Program
Statement of Net Assets
as of June 30, 2005**

	<u>SRF</u>	<u>Management</u>	<u>Total (Memorandum Only)</u>
Assets			
Current Assets:			
Cash and cash equivalents	\$ 7,893,014	\$ 843,695	\$ 8,736,709
Current receivables:			
Loan interest	433,917		433,917
Current portion of loans receivable	2,051,979		2,051,979
Due from other funds	228,436		228,436
Total current receivables	<u>2,714,332</u>	<u>-</u>	<u>2,714,332</u>
Total current assets	10,607,346	843,695	11,451,041
Non-Current Assets:			
Loans receivable, net of current portion:	34,421,359		34,421,359
Allowance for principal forgiveness	<u>(2,651,485)</u>		<u>(2,651,485)</u>
Total non-current assets	31,769,874	-	31,769,874
Total Assets	<u><u>\$ 42,377,220</u></u>	<u><u>\$ 843,695</u></u>	<u><u>\$ 43,220,915</u></u>
Liabilities and Net Assets			
Liabilities:			
Due to Federal Government	\$ 19,623		\$ 19,623
Accounts payable	208,812		208,812
Total liabilities	<u>228,435</u>	<u>-</u>	<u>228,435</u>
Net assets:			
Restricted	42,148,785	843,695	42,992,480
Total Liabilities and Net Assets	<u><u>\$ 42,377,220</u></u>	<u><u>\$ 843,695</u></u>	<u><u>\$ 43,220,915</u></u>

See accompanying notes to the financial statements.

State of New Hampshire
Drinking Water State Revolving Fund Program
Statement of Revenues, Expenses, and Changes in Net Assets
for the Year Ended June 30, 2005

	<u>SRF/Set-Asides</u>	<u>Management</u>	<u>Total (Memorandum Only)</u>
Operating Revenues:			
Loan interest	\$ 956,388		\$ 956,388
Grant revenues	1,978,483		1,978,483
Loan fees		301,847	301,847
Investment earnings	177,316		177,316
Total operating revenues	<u>3,112,187</u>	<u>301,847</u>	<u>3,414,034</u>
Operating Expenses:			
Program administration	324,178	-	324,178
Technical assistance	164,138	-	164,138
State program management	537,529	-	537,529
Local Assistance	952,638	-	952,638
Principal forgiveness expense	750,605	-	750,605
Total operating expenses	<u>2,729,088</u>	<u>-</u>	<u>2,729,088</u>
Operating Income	383,099	301,847	684,946
Fund Equity:			
Contributed capital:			
Federal contribution	3,642,373	-	3,642,373
State contribution	767,547	-	767,547
Total capital contributions	<u>4,409,920</u>	<u>-</u>	<u>4,409,920</u>
Change in net assets	4,793,019	301,847	5,094,866
Net assets, beginning of year	<u>37,355,766</u>	<u>541,848</u>	<u>37,897,614</u>
Net Assets, End of Year	<u><u>\$ 42,148,785</u></u>	<u><u>\$ 843,695</u></u>	<u><u>\$ 42,992,480</u></u>

See accompanying notes to the financial statements.

**State of New Hampshire
Drinking Water State Revolving Fund Program
Statement of Cash Flows
for the Year Ended June 30, 2005**

Cash Flows from Operating Activities:

Loan interest receipts	\$ 760,913
Loan fee receipts	301,847
Receipts from operating grants	1,923,008
Receipts from investments	180,159
Loan principal repayments	2,657,456
Payments for program administration	(327,268)
Payments for technical assistance	(172,149)
Payments for state program management	(480,480)
Payments for source water protection/capacity development	(943,111)
Disbursements on loans	<u>(6,782,313)</u>
Net cash (used) by operating activities	<u><u>(2,881,938)</u></u>

Cash Flows from Noncapital Financing Activities:

Grant from EPA for loans	3,642,373
Funds from State of New Hampshire	<u>767,547</u>
Net cash provided by noncapital financing activities	<u>4,409,920</u>

Net increase (decrease) in cash	1,527,982
Cash and cash equivalents, beginning of year	<u>7,208,727</u>
Cash and cash equivalents, end of year	<u><u>\$ 8,736,709</u></u>

Continued on Next Page

**State of New Hampshire
Drinking Water State Revolving Fund Program
Statement of Cash Flows
for the Year Ended June 30, 2005**

Continued From Previous Page

Reconciliation of Operating (Loss) to Net Cash Used by Operating Activities:

Operating income	\$	684,946
Reconcile to operating income to net cash used by operating activities:		
Loan principal forgiveness		750,605
Change in assets and liabilities:		
(Increase) in interest receivable		(192,095)
Decrease in due from Federal Government		74,794
(Increase) in due from other funds		(228,026)
Increase in accounts payable		154,720
(Decrease) in accrued payroll		(1,488)
(Decrease) in unearned interest		(537)
(Decrease) in construction cost payable		(11,764)
Loan repayments		2,657,456
Loan disbursements		(6,770,549)
Net cash (used) by operating activities	\$	(2,881,938)

See accompanying notes to the financial statements.

NEW HAMPSHIRE DEPARTMENT OF ENVIRONMENTAL SERVICES
Drinking Water State Revolving Fund Program

Notes to Financial Statements

1. Organization of the Program

The New Hampshire Drinking Water State Revolving Fund Program (the Program) was established pursuant to section 1452 (a) of the Safe Drinking Water Act amendments (SDWA) of 1996 and RSA-486:14. The purpose of the SRF is to provide low interest loans to assist public water systems for financing the costs of infrastructure needed to ensure safe drinking water. The loan repayment period ranges from five to twenty years, and all repayments, including interest and principal, must be credited to the Program.

The SRF program is administered by the State of New Hampshire's Department of Environmental Services (NHDES), and consists of a loan fund to record loan and related activity and an administrative fund that collects fees and will in the future, pay the operating costs of the program, and are collectively referred to as the Program. The Department's primary responsibilities for the SRF include obtaining capitalization grants from the Environmental Protection Agency (EPA), soliciting potential interested parties for loans, negotiating loan agreements with local water systems, reviewing and approving payment requests from loan recipients, monitoring the loan repayments, and conducting inspection and engineering reviews to ensure compliance with all applicable laws, regulations, and program requirements. In addition to the loan fund, states are allowed to take portions of this fund for non-infrastructure project activities, or "set-asides", which further the intent of the SDWA. The Program activities (set-asides) include program administration, state program management, water system technical assistance, and local assistance.

On a monthly basis the NHDES charges the Program for time spent on SRF activities by its employees. The charges include the salaries and benefits of employees, as well as indirect costs allocated to the Program. Employees charging time to the Program are covered by the benefits available to State of New Hampshire Employees. The fund is also charged indirect costs through a cost allocation plan agreement between NHDES and U.S. EPA, which is renewed annually.

The Program's financial statements, footnotes, and related schedules are presented for the U.S. Environmental Protection Agency. The Program is included in the State of New Hampshire's comprehensive annual financial report (CAFR) as part of the governmental fund financial statements, which use the modified accrual basis of accounting. Due to differences in reporting methods, there may be differences between the amounts reported in these financial statements and the State's CAFR.

2. Summary of Significant Accounting Policies

Basis of Accounting

The financial statements for the Program are presented as an enterprise fund. As such, the Program is accounted for using the flow of economic resources measurement focus and is maintained on the accrual method of accounting. Under the accrual method of accounting, revenues are recognized when earned and expenses are recorded at the time the liabilities are incurred. All assets and liabilities associated with the operations of the Program are included on the balance sheet. The State

NEW HAMPSHIRE DEPARTMENT OF ENVIRONMENTAL SERVICES
Drinking Water State Revolving Fund Program

Notes to Financial Statements

2. Summary of Significant Accounting Policies

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 on or before November 30, 1989, unless the pronouncements conflict with or contradict GASB pronouncements.

Cash and Cash Equivalents

All monies of the Program are deposited into the State Treasury Department, which is responsible for maintaining these deposits in accordance with New Hampshire State law. The Program considers all such deposits to be cash. The Program, on a monthly basis, receives investment interest earnings on these deposits. According to State law, the Treasurer is responsible for maintaining the cash balances and investing excess cash of the Program, as further discussed in Note 3. Consequently, management of the Program does not have any control over the investment of the excess cash. The statement of cash flows considers all funds deposited with the Treasurer to be cash or cash equivalents.

Loans Receivable

The loans are funded by Federal capitalization grants and State matching funds. The SRF monies are disbursed to borrowers on a cost reimbursement basis. When the borrowers have incurred qualifying expenses, they request a loan disbursement from the Program, and at that time a disbursement is made. Interest begins accruing when funds are disbursed to the borrower. Repayment of the loan begins within six months to one year of construction completion. The Program must receive full repayment within twenty years of project completion. There is no provision for uncollectible accounts, as all repayments are current, and management believes all loans will be repaid according to the loan terms.

Contributed Capital

In accordance with generally accepted accounting principles, funds received from EPA and the State of New Hampshire for the capitalization of the Program are recorded under equity as contributed capital.

3. Cash and Cash Equivalents

GASB Statement No. 40 *Deposits and Investment Risk Disclosures-an amendment of GASB Statement No. 3* was implemented for the fiscal year ended June 30, 2005. As a result, the disclosures related to deposit and investment risks were changed.

Deposits: The following statutory requirements and Treasury Department policies have been adopted to minimize risk associated with deposits:

NEW HAMPSHIRE DEPARTMENT OF ENVIRONMENTAL SERVICES
Drinking Water State Revolving Fund Program

Notes to Financial Statements

3. Cash and Cash Equivalents

RSA 6:7 establishes the policy the state Treasurer must adhere to when depositing public monies. Operating funds are invested per investment policies that further define appropriate investment choices and constraints as they apply to those investment types.

Custodial Credit Risk: The custodial risk for deposits is the risk that in the event of a bank failure, the Program's fund deposits may not be recovered.

Custodial credit risk is managed in a variety of ways. Although State law does not require deposits to be collateralized, the Treasurer does utilize such arrangements where prudent and/or cost effective. All banks, where the State has deposits and/or active accounts, are monitored as to their financial health through the services of Veribanc, Inc., a bank rating firm. In addition, ongoing reviews with officials of depository institutions are used to allow for frequent monitoring of custodial credit risk.

All depositories used by the State must be approved at least annually by the Governor and Executive Council. All commercial paper must be from issuers having an A1/P1 rating or better and an AA- or better long-term debt rating from one or more of the nationally recognized rating agencies. Certificates of deposits must be with state or federally chartered banking institutions with a branch in New Hampshire. The institution must have the highest rating as measured by Veribanc, Inc.

Whereas all payments made to the State are to be in U.S. dollars, foreign currency risk is essentially nonexistent on State deposits.

Interest Rate Risk: Interest rate risk is the risk that changes in interest rates will adversely affect the value of the State's investments. The State measures the interest rate risk using the weighted average maturity method (WAM). The State's WAM is dollar weighted in terms of years.

All cash in the Program is deposited with the State Treasurer who is responsible for maintaining and investing the pooled cash balances in accordance with State laws. The Treasurer is required to maintain a mix of investments in order to allow funds to be withdrawn at any time to meet normal operating needs. The Program's share of the investment income from the local government investment pool is based on the average daily balance for the period and is credited to the Program monthly.

During the most of fiscal year 2005, all cash was primarily invested in the demand deposit account and the repurchase agreements. Cash is managed in the local government investment pool, and is stated at cost, which approximates fair market value. Investments in local government pools are not categorized because they are not evidenced by securities that exist in physical or book entry form.

	<u>Carrying Amount</u>
Not subject to categorization:	
Local government investment pool	\$8,736,709 =====

NEW HAMPSHIRE DEPARTMENT OF ENVIRONMENTAL SERVICES
Drinking Water State Revolving Fund Program

Notes to Financial Statements

4. Loans Receivable

The Program makes loans to qualified entities at interest rates ranging from .1525 percent to 2.688 percent. Interest rates are initially set in the original loan agreement, and then when the project is completed a supplemental loan agreement is made which fixes the final interest rate to be charged at the lower of the original loan agreement or prevailing market rate, per the following formula:

<u>Loan Term</u>	<u>Interest Rate</u>
5 years	25% of market minus 1%
10 years	50% of market minus 1%
15 years	75% of market minus 1%
20 years	80% of market minus 1%

Details of loans receivable as of June 30, 2005 are as follows:

Loan Status	Loan Amount Authorized	Remaining Commitment	Loan Balance June 30, 2004	Loan Disbursements	Repayments & Principal Forgiveness	Loan Balance June 30, 2005
Funding Completed	\$ 36,833,440	\$ -	\$ 29,743,805	\$ 961,956	\$ (2,255,640)	\$ 28,450,121
Funding in Progress	30,049,905	22,026,687	2,721,513	5,301,705		8,023,218
Loans Paid Off	5,617,600	-	199,354	506,887	(706,241)	-
Total	<u>\$ 72,500,945</u>	<u>\$ 22,026,687</u>	<u>\$ 32,664,672</u>	<u>\$ 6,770,548</u>	<u>\$ (2,961,881)</u>	<u>\$ 36,473,339</u>

**NEW HAMPSHIRE DEPARTMENT OF ENVIRONMENTAL SERVICES
Drinking Water State Revolving Fund Program**

Notes to Financial Statements

4. Loans Receivable

The Program made loans to eight local communities that totaled \$1 million or more, and in the aggregate, exceed \$26 million. The outstanding balances of these loans represent approximately 73 percent of the total loans outstanding as of June 30, 2005.

<u>Community</u>	<u>Loan Authorized</u>	<u>Loan Outstanding</u>	<u>Percentage of Total Outstanding</u>
Berlin Water Works	9,506,246	8,165,283	22.39%
City of Portsmouth	5,962,560	5,366,304	14.71%
City of Manchester	5,008,820	4,112,839	11.28%
Hanover Water Works	4,035,000	3,556,036	9.75%
Town of Raymond	2,500,000	2,375,000	6.51%
Town of Exeter	1,354,340	1,083,472	2.97%
Tilton/Northfield Aqueduct	1,293,694	1,047,011	2.87%
Town of Northumberland	2,031,018	1,001,960	2.75%
Subtotal More than \$1 Million	31,691,678	26,707,905	73.23%
All Other Loans	32,983,913	9,765,434	26.77%
Total Loans	<u>64,675,591</u>	<u>36,473,339</u>	<u>100.00%</u>

Loans mature at various intervals through May 2025. The scheduled principal and interest amounts on completely disbursed loans maturing in the next five years and every five years thereafter are as follows:

<u>FY June 30</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2006	\$ 2,225,936	\$ 685,734	\$ 2,911,670
2007	2,178,744	652,678	2,831,422
2008	2,194,042	612,037	2,806,079
2009	2,212,690	570,918	2,783,608
2010	1,523,202	529,344	2,052,546
2011 - 2015	7,693,534	2,032,919	9,726,453
2016 - 2020	7,323,762	995,088	8,318,850
2021 - 2025	3,098,211	158,075	3,256,286
Total	<u>\$ 28,450,121</u>	<u>\$ 6,236,793</u>	<u>\$ 3,686,914</u>

**NEW HAMPSHIRE DEPARTMENT OF ENVIRONMENTAL SERVICES
Drinking Water State Revolving Fund Program**

Notes to Financial Statements

5. Contributed Capital

The Program is capitalized by annual grants through EPA. These grants have been awarded annually. The State of New Hampshire must also contribute an amount equal to 20 percent of the federal capitalization amount. New Hampshire's matching contribution has been provided through appropriation of State general fund resource and general obligation bonds of the State. As of June 30, 2005, EPA has awarded \$68,225,700 to the State, of which \$45,397,570 has been drawn for loans and set-aside expenses. The following summarizes the capitalization grant award, amounts drawn on each grant as of the balance sheet date, and balances available for future loans and set-aside costs:

Grant Year	Grant Amount	Total Draws as of June 30, 2004	2005 Draws	Total Draws as of June 30, 2005	Grant Funds Available June 30, 2005
1997	\$ 13,754,800	\$ 13,754,800	\$ -	\$ 13,754,800	\$ -
1998	7,121,300	7,121,300		7,121,300	-
1999	7,463,800	7,463,800		7,463,800	-
2000	7,757,000	6,643,421	943,111	7,586,532	170,468
2001	7,789,100	3,187,595	3,433,140	6,620,735	1,168,365
2002	8,052,500	1,450,468	409,943	1,860,411	6,192,089
2003	8,004,100	210,805	341,129	551,934	7,452,166
2004	8,283,100		438,058	438,058	7,845,042
Total	\$ 68,225,700	\$ 39,832,189	\$ 5,565,381	\$ 45,397,570	\$ 22,828,130

As of June 30, 2005, State matching contributions were as follows:

	Total Match As of June 30, 2004	2005 Contributions	Total Match As of June 30, 2005
New Hampshire State Match	\$ 7,775,397	\$ 767,547	\$ 8,542,944

NEW HAMPSHIRE DEPARTMENT OF ENVIRONMENTAL SERVICES
Drinking Water State Revolving Fund Program

Notes to Financial Statements

6. Set-Asides

Of the capitalization grants, the following summarizes the set-aside grants, amounts drawn on each set-aside as of the balance sheet date, and balances available for future set-aside costs:

Grant Year	Administration	Technical Assistance	State Program Management	Local Assistance	Total
1997	\$ 550,192	\$ 275,096	\$ 233,049	\$ 2,063,220	\$ 3,121,557
1998	284,852	142,426	712,130	1,068,195	2,207,603
1999		149,276		1,119,570	1,268,846
2000		155,140	268,014	1,163,550	1,586,704
2001	76,356	155,782	503,520	1,168,365	1,904,023
2002	754,881	161,050	735,247	231,436	1,882,614
2003	155,597	160,082	265,294	10,138	591,111
2004	312,124	166,062	830,310	-	1,308,496
Total Grant	2,134,002	1,364,914	3,547,564	6,824,474	13,870,954
Draws thru June 30, 2004	(1,465,571)	(1,110,325)	(2,591,210)	(4,300,956)	(9,468,062)
2005 Draws	(327,268)	(172,149)	(480,480)	(943,111)	(1,923,008)
Available, June 30, 2005	\$ 341,163	\$ 82,440	\$ 475,874	\$ 1,580,407	\$ 2,479,884

7. Contingencies, Related Parties, and Subsequent Events

Contingencies

The Program is exposed to various risks of loss related to torts, thefts of assets, errors or omissions, injuries to state employees while performing the Program business, or acts of God. The State maintains insurance for all risks of loss, which is included in the indirect costs allocated to the Program.

According to NHDES management and legal counsel, there are no other loss contingencies which require disclosure or accrual under the Statement of Financial Accounting Standards No. 5.

Related Parties

There are no related party transactions with or related amounts receivable from management of the Programs.

**Independent Auditor's Report on Internal Control Over Financial Reporting and
on Compliance and Other Matters Based on an Audit of Financial Statements
Performed in Accordance with *Government Auditing Standards***



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

OFFICE OF
INSPECTOR GENERAL

We have audited the financial statements of the State of New Hampshire Drinking Water State Revolving Fund Program (the Program) as of and for the year ended June 30, 2005, and have issued our report thereon dated May 24, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Program's internal control over financial reporting 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 over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. 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 Program's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the findings, recommendations, and responses.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud 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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we consider the reportable conditions described in the accompanying schedule of findings, recommendations, and responses to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Program's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a

direct and material effect on the determination of financial statement amounts. This included tests of specific program requirements governing allowability for specific activities, allowable types of assistance, State matching, period of availability of funds and binding commitments, cash management, program income, and subrecipient monitoring that are applicable to the Program for the year ended June 30, 2005.

The management of the Program is responsible for the Program's compliance with those requirements. Our responsibility is to express an opinion on those requirements based on our audit. An audit includes examining, on a test basis, evidence about the Program'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 sections that follow, the Program complied, in all material respects, with the specific program requirements that are applicable to the Program for the year ended June 30, 2005.

This report is intended solely for the information and use of management of the Program and the U.S. Environmental Protection Agency, and is not intended to be and should not be used by anyone other than these specified parties.

Office of Inspector General
May 24, 2006

Internal Control Findings, Recommendations, and Responses

Control Environment Needs Improvement

The foundation of the accounting and reporting system is the control environment established by management. Management sets the tone of the organization, and determines the accounting systems and procedures to be used. Management also establishes the necessary controls and policies to assure that the assertions inherent in an accounting system are followed.

The management assertions include:

- **Existence or occurrence:** The assets and liabilities of the organization exist at a given date, and recorded transactions occurred during the proper period.
- **Completeness:** All transactions and accounts that should be included are included in the accounting system.
- **Valuation or allocation:** The accounts are recorded and presented at appropriate amounts.

The DWSRF is accounted for and reported within the New Hampshire Department of Environmental Services' (NHDES) General Fund. To facilitate program reporting required by the U.S. Environmental Protection Agency (EPA), NHDES maintains a separate DWSRF accounting system and provides EPA with program-specific financial statements. We noted deficiencies in the design and operations of NHDES' internal controls for the DWSRF-specific financial accounting and reporting that, in our judgment, could adversely affect NHDES' ability to record, process, and report financial data consistent with the assertions of management in the DWSRF financial statements. These conditions appear to have resulted, in part, from (1) the use of a separate spreadsheet-based accounting system that a limited number of employees and management are familiar with; (2) a lack of adequate training on the DWSRF-specific accounting system; (3) inadequate written procedures for key areas such as monthly reconciliations to the DWSRF general ledger and DWSRF financial reporting; (4) lack of management understanding, review, and approval of entries to the DWSRF general ledger and supporting schedules; and (5) significant turnover of key staff and management working in the DWSRF program over the last 2 years. Specifically, we noted problems with the effectiveness of management assertions as follows.

Existence or Occurrence: Periodic reconciliations of the DWSRF accounting records to the actual cash and investment deposits maintained by the Treasurer is an important control aspect that can provide assurances that the accounting records properly record cash and investment transactions and balances. Management review of these reconciliations provides assurances that these controls are working as intended.

We found that NHDES was reconciling the account used to deposit Federal draws and related State match (the "zero balance account") and the account used for loan

repayments and disbursements ("the repayment account"), but it was not adjusting for errors and other reconciling items in the DWSRF general ledger. Several other errors between the loan interest and management fees were identified, but not corrected. As a result, cash was overstated by \$3,941,721 and short-term investments were understated by \$4,000,000 as of June 30, 2005.

Completeness: NHDES' accounting system is not specifically designed for the State Revolving Funds program. Therefore, the DWSRF accountant maintains a separate spreadsheet-based DWSRF general ledger to generate the DWSRF financial statements. This general ledger was not properly reconciled to original source documentation. We encountered numerous unrecorded transactions and errors in the DWSRF general ledger that went undetected during the period because DWSRF Program management did not have procedures in place for approval of the transactions and periodic review of the general ledger. As a result, control and accountability over State Revolving Funds is diminished and there is no assurance that the funds are accounted for properly.

Valuation or Allocation: The amounts recorded in the DWSRF general ledger for loans and related interest receivable should be supported by a subsidiary schedule(s) that provide details by specific loan. Loans included on the schedule should be supported by the proper loan documentation (e.g., loan agreement, requests for disbursements, loan amortizations schedules). The subsidiary schedules should be periodically reconciled to the DWSRF general ledger.

We discovered numerous instances where the balances of the DWSRF general ledger accounts were incorrect. Journal entries were incorrectly made because of a lack of understanding of how the system was designed, a lack of documentation of proper year-end accounting procedures and closeouts, and the absence of training for new staff and management. For example, the year-end reclassifying journal entries for Federal funds and the fund balance were overstated by \$9.5 million and understated by the same amount, respectively, in the DWSRF general ledger. Also, the required State match was underfunded by \$228,436 due to the State using the wrong percentage to calculate the required matching funds. The State calculated its share at 17 percent of the capitalization grants instead of the required percentage, which was 20 percent.

Amortization schedules for 5 of the 13 loans executed during the last 2 fiscal years were prepared incorrectly. Two of the five resulted in improper accounting for principal forgivenesses and the principal amounts. We also identified a number of loan repayments that were not recorded. The Program does not have procedures in place to detect these omissions. Proper reconciliations to the supporting documents, disbursement and amortizations schedules, and the DWSRF general ledger would have detected these errors.

The short-term investment was understated by \$4,000,000 in the DWSRF general ledger. A \$2,000,000 purchase of short-term investments was not recorded. A \$500,000 short-term investment was under recorded at its maturity, and another \$500,000 short-term investment in another instance was over recorded at its maturity. These errors appeared to be due to the lack of coordination with the State of New Hampshire Treasury, lack of

subsidiary records to support the general ledger, and lack of proper reconciliations to the subsidiary records and the DWSRF general ledger.

Recommendations

We recommend that EPA Regional Administrator, Region 1, require the NHDES to:

1. Coordinate with the State of New Hampshire Treasury and obtain up-to-date documentation on specific cash and investment transactions and balances. A schedule of cash, investments, and related earnings per the State Treasurer should be properly reconciled with supporting documents and the DWSRF general ledger on a recurring basis. DWSRF program management should gain an understanding of the reconciliation process and review and assess the reconciliations on a periodic basis.

Prior to our audit, NHDES had recognized the need to improve its DWSRF-specific accounting and management system. NHDES is currently in the process of developing a new system expected to address this condition.

2. Properly reconcile its subsidiary schedule(s) for loans and interest receivable with the DWSRF general ledger on a recurring basis. DWSRF program management should gain an understanding of the reconciliation process and review the reconciliations on a periodic basis.

Prior to our audit, NHDES had recognized the need to improve its DWSRF-specific accounting and management system and is in the process of developing a system that is expected to correct this condition.

3. Develop and implement procedures for appropriate review and approval of accounting entries and reporting from the DWSRF-specific accounting system, including year-end closing and reporting.
4. Develop training on the DWSRF-specific accounting system for all appropriate staff and management, including the accountants, accounting manager, and program manager.

State's Response

The State responded on February 14, 2007, with the following:

With regards to the comments on the accounting system, DES is in the middle of a system conversion from our manual, Excel spreadsheet based, system to a general ledger system. When this system conversion is complete, the majority of the posting and reconciliation issues will be resolved as we will have one integrated accounting package. All appropriate staff will be trained on using this system including accountants, accounting manager and program managers.

Procedures have been developed for preparing accounting entries and for their appropriate management review and approval and for the reconciliation of subsidiary schedules to the general ledger.

Concerning the State Treasury, we are working with that department to improve the timely receipt of SRF documents from them in order for DES to perform our reconciliations and postings in a timely manner.

OIG's Response

We find the State's response to be acceptable.

Compliance Findings, Recommendations, and Responses

State Match Calculations Incorrect

As of June 30, 2005, NHDES had received \$228,436 in excess Federal funds and had a \$228,436 shortfall in State funds required to be in the revolving loan fund. Pursuant to Title 40, Code of Federal Regulations (CFR), Section 35.3550(g), the State is to deposit 20 percent of each capitalization grant into the revolving loan fund. However, the State provided matching funds based on 17 percent of the capitalization grant, which resulted in a shortfall of \$228,436. Each Federal draw associated with the shortfall was regarded as an erroneous payment by EPA to the State pursuant to Office of Management and Budget (OMB) Circular No. A-11, Section 57.1.

Set-Aside Costs Need to Be Separate and Identifiable for Each Set-Aside by Actual Costs

NHDES has only one code 4718 for charging all set-aside activities, and charges budgeted time for each employee instead of actual time worked on each set-aside. There are four kinds of set-asides in the Program, as defined in 40 CFR 35.3535(b)-(e):

Description	NHDES Accounting Code	Allowed Percentage Use of Capitalization Grants
Administration	D	4%
Small systems technical assistance	E	2%
State program management	F	10%
Local assistance and other State programs	G	15%

40 CFR 35.3540 (b) requires that a State must maintain separate and identifiable set-aside accounts for the portion of its capitalization grant to be used for set-aside activities. The State agency that is awarded the capitalization grant is accountable for the use of the funds provided in the capitalization grant agreement under the general grant regulations at 40 CFR Part 31. 40 CFR 31.22 (b) states that allowable costs are to be determined in accordance with the cost principles in OMB Circular A-87. Attachment B, §8(h) of OMB Circular A-87 provides the requirements for support of salaries and wages charged to Federal programs. When employees work on multiple activities or cost objectives, a distribution of their salaries or wages are to be supported by personnel activity reports that meet the standards in §8(h)(5), which state that the activity report must reflect an after-the-fact distribution of the actual activity of each employee and that budget estimates do not qualify as support for charges.

Employees in the NHDES Water Supply Engineering Bureau are assigned to specific set-asides by budget, and a list of these employees is provided to the DWSRF accountant. Employees working on set-aside activities charge Organization Code 4718 for all activities. The DWSRF accountant then enters letter codes to the corresponding set-aside employees' payroll transactions according to the list in order to identify costs for each set-aside. As a result, budgeted time, not actual time, is charged to the set-aside accounts. Since the charges were not adequately supported, they would be considered erroneous payments as defined by OMB Circular A-11.

For example, an employee was promoted to a supervisory position during the year; however, the accountant coded and charged the employee's time to the 15-percent set-aside even though the employee's responsibilities changed. The costs should have been allocated to three set-asides – 4 percent, 10 percent, and 15 percent – based on the actual time spent on each activity. Based on budgeted time, \$30,538 of this employee's time was charged to the wrong set-aside account. The actual cost of this employee's time that should have been charged to each set-aside activity is not known since employee did not maintain records of the activities they performed.

Subrecipient Monitoring Not Performed

OMB Circular A-133 and 40 CFR 31.26 require that a pass-through entity ensure that subrecipients expending \$500,000 or more in Federal awards during the subrecipient's fiscal year meet the Single Audit requirements for that fiscal year. The pass through entity is to issue a management decision on any audit findings within 6 months after receipt of the subrecipient's audit report and ensure that the subrecipient takes appropriate and timely corrective action.

NHDES did not have procedures in place to ensure that borrowers expending Federal awards met the Single Audit requirements to issue management decisions within 6 months of receipt of the audit reports, and to ensure that subrecipients took appropriate and timely corrective action. Program management was not aware that the monitoring of and response to Single Audit requirements was necessary. As a result, NHDES was unaware of the Single Audit status of its borrowers and, thus, whether the borrowers' audits had uncovered any issues of noncompliance.

Recommendations

We recommend that EPA Regional Administrator, Region 1, require the NHDES to:

5. Deposit \$228,436 to correct the underfunded State matching funds, and calculate future matching contributions according to the appropriate formula.
6. Establish subcodes for each set-aside so that employees, not the Program accountant, identify and charge set-aside activities on their timesheets.

By the end of the audit field work, we noted that the State had already established subcodes for each set-aside, and employees identified set-aside activities on their timesheets instead of being coded by the Program accountant later.

7. Implement a Single Audit report review and corrective action policy consistent with OMB Circular A-133 and EPA regulations.

State's Response

The State responded on February 14, 2007, with the following:

The DWSRF state match percentage has been corrected and DES made-up the under funding issue of \$228,436 in State Fiscal Year 2006.

OIG's Response

The State has adequately addressed recommendations 5 and 6. However, the State did not respond to the recommendation of implementing a Single Audit report review. EPA Region 1 should work with the State to assure that it meets the requirements of OMB Circular A-133 and 40 CFR 31.26 regarding pass-through entity responsibilities for followup on subrecipient audits.

Supplemental Information

**State of New Hampshire
Drinking Water State Revolving Fund Program
Schedule of Set-Aside Expenses
Year Ended June 30, 2005**

<u>Description</u>	<u>Administration</u>	<u>Technical Assistance</u>	<u>State Program Management</u>	<u>Local Assistance</u>	<u>Total</u>
Payroll	\$ 206,866	\$ -	\$ 347,671	\$ 773,684	\$ 1,328,221
Contracts	12,289	164,138	-	20,023	196,450
Grants	-	-	41,736	138,465	180,201
Rent	44,430	-	-	-	44,430
Indirect Cost	38,244	-	-	-	38,244
Travel	1,024	-	18,890	12,177	32,091
Other Operating Costs	21,326	-	129,232	8,289	158,847
Total	<u>\$ 324,178</u>	<u>\$ 164,138</u>	<u>\$ 537,529</u>	<u>\$ 952,638</u>	<u>\$ 1,978,483</u>

Status of Recommendations and Potential Monetary Benefits

RECOMMENDATIONS						POTENTIAL MONETARY BENEFITS (in \$000s)	
Rec. No.	Page No.	Subject	Status ¹	Action Official	Planned Completion Date	Claimed Amount	Agreed To Amount
1	18	Coordinate with the State of New Hampshire Treasury and obtain up-to-date documentation on specific cash and investment transactions and balances. A schedule of cash, investments, and related earnings per the State Treasurer should be properly reconciled with supporting documents and the DWSRF general ledger on a recurring basis. DWSRF program management should gain an understanding of the reconciliation process and review and assess the reconciliations on a periodic basis.	O	EPA Regional Administrator, Region 1			
2	18	Properly reconcile its subsidiary schedule(s) for loans and interest receivable with the DWSRF general ledger on a recurring basis. DWSRF program management should gain an understanding of the reconciliation process and review the reconciliations on a periodic basis.	O	EPA Regional Administrator, Region 1			
3	18	Develop and implement procedures for appropriate review and approval of accounting entries and reporting from the DWSRF-specific accounting system, including year-end closing and reporting.	O	EPA Regional Administrator, Region 1			
4	18	Develop training on the DWSRF-specific accounting system for all appropriate staff and management, including the accountants, accounting manager, and program manager.	O	EPA Regional Administrator, Region 1			
5	21	Deposit \$228,436 to correct the underfunded State matching funds, and calculate future matching contributions according to the appropriate formula.	C	EPA Regional Administrator, Region 1	State Fiscal Year 2006	\$228	\$228
6	21	Establish subcodes for each set-aside so that employees, not the Program accountant, identify and charge set-aside activities on their timesheets.	C	EPA Regional Administrator, Region 1	04/06/06		
7	21	Implement a Single Audit report review and corrective action policy consistent with OMB Circular A-133 and EPA regulations.	U	EPA Regional Administrator, Region 1			

¹ O = recommendation is open with agreed-to corrective actions pending;
C = recommendation is closed with all agreed-to actions completed;
U = recommendation is undecided with resolution efforts in progress

Distribution

EPA Region 1

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Director of Office of Ecosystem Protection
Manager of Municipal Assistance Unit
Audit Liaison
DWSRF Coordinator

EPA Headquarters

Director, Grants Administration Division
Agency Followup Coordinator
Infrastructure Branch Chief
DWSRF Coordinator
DWSRF Audit Manager

New Hampshire Department of Environmental Services

Commissioner
Chief Operating Officer
DWSRF Administrator