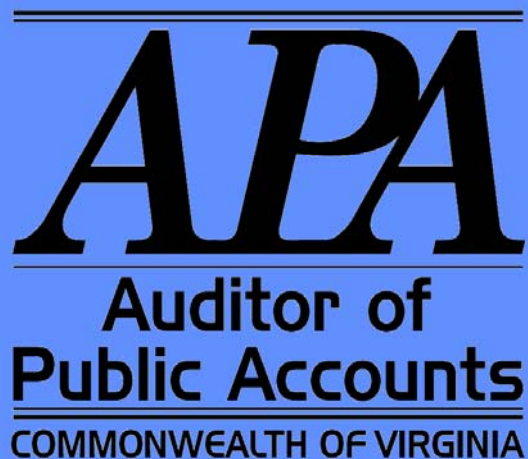


DEPARTMENT OF ENVIRONMENTAL QUALITY

**REPORT ON AUDIT
FOR THE YEARS ENDING
JUNE 30, 2008 AND JUNE 30, 2009**



AUDIT SUMMARY

Our audit of the Department of Environmental Quality for the fiscal years ending June 30, 2008 and 2009 found:

- proper recording and reporting of all transactions, in all material respects, in the Commonwealth Accounting and Reporting System and the internal accounting system of the Department;
- no matters involving internal control and its operations necessary to bring to management's attention;
- compliance with applicable laws, regulations, and provisions of contracts or grant agreements; and
- the Department has adequately addressed deficiencies identified in the prior year audit report.

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AGENCY HIGHLIGHTS

The Department of Environmental Quality (Environmental Quality) protects the Commonwealth of Virginia's natural resources by administering state and federal environmental programs, issuing permits, monitoring water and air quality, and inspecting water facilities. Additionally, Environmental Quality conducts extensive monitoring to ensure compliance with state and federal standards for water quality, air quality, and waste management. Environmental Quality also enforces regulations promulgated by the State Water Control Board, the Board of Waste Management, and the Air Pollution Control Board.

Environmental Quality operates through its central office, six regional offices, and two satellite and specialized offices. Major operations involve technical and financial assistance to communities and businesses to protect environmental resources; permit, compliance and response programs for air, land, and water resources; and management of remediation and response programs. As part of administering these programs, Environmental Quality uses various funds to account for the collection and disbursement of program funding and we discuss some of the more significant funds below.

Virginia Water Quality Improvement Fund

The Virginia Water Quality Improvement Fund finances nutrient removal strategies for the Chesapeake Bay and its tributaries. It receives funding from the General Fund, as appropriated by the General Assembly, and statutory funding as provided in the Code of Virginia. The Code of Virginia requires that ten percent of the annual statewide General Fund revenue collections which exceed the official estimates in the General Appropriation Act, and ten percent of any unreserved statewide General Fund balance at the close of each fiscal year not mandated for re-appropriation go into the fund. Fifteen percent of mandatory deposits that result from General Fund surpluses are set aside in a reserve for appropriation in years when the Commonwealth does not have a General Fund budget surplus. As of June 30, 2009, the Water Quality Improvement Fund had a cash balance of \$70 million.

Environmental Quality and the Department of Conservation and Recreation jointly manage the Virginia Water Quality Improvement Fund. Environmental Quality provides funding to publicly-owned treatment works for the purpose of designing and installing biological nutrient removal facilities within the Chesapeake Bay watershed to control point source pollution. The Department of Conservation and Recreation provides funding to local governments, soil and water conservation districts, institutions of higher education, and individuals to lower the amount of non-point source pollution washed from the land within the Chesapeake Bay watershed.

Virginia Clean Water Revolving Loan Fund

The Virginia Clean Water Revolving Loan Fund provides a long-term renewable funding source for wastewater treatment improvement. The capitalization grant program, established by the Federal Water Quality Act, provides an annual source of federal funds for the loan fund. The loan fund offers long-term, low interest rate loans to local governments to construct or maintain infrastructures necessary to comply with the Clean Water Act requirements. Environmental Quality contracts with the Virginia Resource Authority to manage the resources of the revolving loan fund, while Environmental Quality retains the responsibility of reviewing and approving all disbursements of the fund.

During fiscal year 2009, Environmental Quality received a small portion of federal funding from the American Recovery and Reinvestment Act (ARRA). Environmental Quality expects ARRA funding for the capitalization grant program to increase significantly throughout fiscal years 2010 and 2011. The funding is currently part of the revolving loan fund program and Environmental Quality manages the disbursements accordingly.

The Virginia Petroleum Storage Tank Fund

The Virginia Petroleum Storage Tank Fund reimburses approved clean-up costs and some third-party damages resulting from petroleum releases from storage tanks. The primary revenue for the Fund comes from a \$.006 per gallon fee on regulated petroleum products sold in the Commonwealth. Regulated products include gasoline, aviation motor fuel, diesel fuel, kerosene, and heating oil.

FINANCIAL HIGHLIGHTS

Environmental Quality receives funding from multiple sources including general fund appropriations, special revenue funds, and federal grants. The tables below show Environmental Quality's 2008 and 2009 original and final operating budget and actual operating expenses by fund. There were significant changes between the original and final budget in several of the funds.

In fiscal year 2009, the General Fund original budget decreased by \$5 million during the year as a result of the statewide budget reduction plan. Environmental Quality took several actions to absorb these reductions including reducing the match for the revolving loan fund. The General Fund budget also decreased from original to final budget in fiscal year 2008 due to statewide budget reduction actions. The General Assembly eliminated a \$15 million deposit to the Water Quality Improvement Fund.

There were significant increases from the original to final budget for the Water Quality Improvement Fund in both fiscal years. The primary reason for the increases is Environmental Quality receives additional appropriations during the year to carry forward their prior year cash balances. Environmental Quality makes payments from the Water Quality Improvement Fund based on construction progress and obligations to local governments. This often results in a time-lag in obligation and disbursement of the funds, creating a variance between the budget and actual expenses.

The Clean Water Revolving Loan Fund has no original budget in both years because funding comes from a transfer each year of Federal Funds. Environmental Quality draws down Capitalization grant funds from the federal government during the year and then transfers funding to the Clean Water Revolving Loan Fund. This transfer of funding explains the increase in the Clean Water Revolving Loan Fund, since Environmental Quality reports the expenses in this fund and not in the Federal Funds, where there is a corresponding budget reduction for the transfer in both years.

Analysis of Budgeted and Actual Expenses by Fund for Fiscal Year Ended June 30, 2009

	<u>Original Budget</u>	<u>Final Budget</u>	<u>Expenses</u>
General Fund	\$ 45,916,956	\$ 40,955,909	\$ 40,146,056
Special Revenue Funds:			
Water Quality Improvement Fund	55,700,000	212,538,514	163,219,415
Clean Water Revolving Loan Fund	-	32,509,583	29,116,598
Petroleum Storage Tank Fund	37,050,321	36,776,491	34,090,269
Other*	27,447,320	29,288,890	23,257,433
Enterprise Fund	12,287,239	12,287,239	11,024,900
Federal Fund	<u>45,174,917</u>	<u>21,587,764</u>	<u>16,233,797</u>
Total	<u>\$223,576,753</u>	<u>\$385,944,390</u>	<u>\$317,088,468</u>

Analysis of Budgeted and Actual Expenses by Fund for Fiscal Year Ended June 30, 2008

	<u>Original Budget</u>	<u>Final Budget</u>	<u>Expenses</u>
General Fund	\$ 67,770,523	\$ 48,859,854	\$ 48,549,031
Special Revenue Funds:			
Water Quality Improvement Fund	5,700,000	94,067,578	51,577,408
Clean Water Revolving Loan Fund	-	21,062,448	13,140,873
Petroleum Storage Tank Fund	37,299,305	37,299,305	35,978,850
Other*	25,488,492	28,024,548	22,514,716
Enterprise Fund	10,808,736	11,618,736	11,536,214
Federal Fund	<u>42,573,018</u>	<u>19,445,269</u>	<u>18,824,745</u>
Total	<u>\$189,640,074</u>	<u>\$260,377,738</u>	<u>\$202,121,837</u>

*Includes other special revenue funds and trust and agency funds

Source: Commonwealth Accounting and Reporting System

The following table compares Environmental Quality's expenses by major category for fiscal years 2008 and 2009. Transfer payments is the largest category of expenses, making up 57 percent and 74 percent for fiscal years 2008 and 2009 respectively. This category is broken into subcategories to illustrate the different sources used to provide assistance to other entities.

Expenses by Major Category

	<u>2009</u>	<u>2008</u>
Personal services	\$ 60,942,378	\$ 64,405,354
Contractual services	15,016,543	16,414,338
Supplies and materials	694,547	787,130
Transfer payments		
Payments to Local Governments and Other Entities:		
Water Quality Improvement Fund	163,219,416	51,577,408
Clean Water Revolving Loan Fund	29,078,631	16,743,742
Petroleum Storage Tank Fund	23,928,617	25,756,678
Combined Sewer Overflow Matching Fund	3,000,000	6,100,000
Other Grants and Financial Assistance	3,309,864	2,907,630
Operating permits program	3,203,839	3,356,800
Incentives to recycle waste tires	3,062,988	2,502,944
Other transfer payments	<u>5,589,131</u>	<u>6,205,323</u>
Total transfer payments	<u>234,392,486</u>	<u>115,150,525</u>
Continuous charges	5,029,217	4,714,800
Property and improvements	13,369	390
Equipment	873,842	614,244
Plant and improvements	<u>126,086</u>	<u>35,056</u>
Total	<u>\$ 317,088,468</u>	<u>\$202,121,837</u>

Source: Commonwealth Accounting and Reporting System

Clean Water Revolving Loan Fund expenses increased by 121 percent during fiscal year 2009 as a result of construction project grants. The timing of expenses for construction loans is variable and dependent upon the progress of each project. In addition, project expenses for Water Quality Improvement Fund obligations continue to increase every fiscal year.



Commonwealth of Virginia

Auditor of Public Accounts
P.O. Box 1295
Richmond, Virginia 23218

Walter J. Kucharski, Auditor

May 12, 2010

The Honorable Robert F. McDonnell
Governor of Virginia
State Capital
Richmond, Virginia

The Honorable Charles J. Colgan
Chairman, Joint Legislative Audit
and Review Commission
General Assembly Building
Richmond, Virginia

We have audited the financial records and operations of the **Virginia Department of Environmental Quality** (Environmental Quality) for the years ended June 30, 2008 and June 30, 2009. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Audit Objectives

Our audit's primary objectives were to evaluate the accuracy of recorded financial transactions in the Commonwealth Accounting and Reporting System and in Environmental Quality's internal accounting system, review the adequacy of Environmental Quality's internal controls, test compliance with applicable laws and regulations, and review corrective actions of audit findings from prior year reports.

Audit Scope and Methodology

Environmental Quality's management has responsibility for establishing and maintaining internal control and complying with applicable laws and regulations. Internal control is a process designed to provide reasonable, but not absolute, assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

We gained an understanding of the overall internal controls, both automated and manual, sufficient to plan the audit. We considered significance and risk in determining the nature and extent of our audit procedures. Our review encompassed controls over the following significant cycles, classes of transactions, and account balances.

Federal Grant Revenues and Expenditures
Small Purchase Charge Card
Network Security
Clean Water Revolving Loan Fund
Revenues and Expenditures

Contractual Services Expenditures
Travel Expenditures
Cash Receipting

Our audit did not include the physical security of the Commonwealth Enterprise Solutions Center, where Environmental Quality's system infrastructure is housed, as it is owned by Northrop Grumman Corporation and auditing of physical security is the responsibility of their external auditors.

We performed audit tests to determine whether the Environmental Quality's controls were adequate, had been placed in operation, and were being followed. Our audit also included tests of compliance with provisions of applicable laws and regulations. Our audit procedures included inquiries of appropriate personnel, inspection of documents, records, and contracts, and observation of Environmental Quality's operations. We tested transactions and performed analytical procedures, including budgetary and trend analyses.

Conclusions

We found that Environmental Quality properly stated, in all material respects, the amounts recorded and reported in the Commonwealth Accounting and Reporting System and in Environmental Quality's internal accounting system. Environmental Quality records its financial transactions on the cash basis of accounting, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America. The financial information presented in this report came directly from the Commonwealth Accounting and Reporting System.

We noted no matters involving internal control and its operation that we consider necessary to be reported to management. The results of our tests of compliance with applicable laws and regulations disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards.

Environmental Quality has taken adequate corrective action with respect to audit findings reported in the prior year that are not repeated in this letter.

Exit Conference and Report Distribution

We discussed this report with management on June 2, 2010.

This report is intended for the information and use of the Governor and General Assembly, management, and the citizens of the Commonwealth of Virginia and is a public record.

AUDITOR OF PUBLIC ACCOUNTS

RH: alh

DEPARTMENT OF ENVIRONMENTAL QUALITY

David K. Paylor, Director

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